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Using nonqualified deferred annuities to fund stand-alone long-term care insurance

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KEY HIGHLIGHTS

Tax-free exchanges from nonqualified deferred annuities to fund stand-alone LTC insurance are now permitted

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Creates the possibility of using pre-tax deferral amounts to pay the premiums on stand-alone LTC and receive tax-free LTC benefits in the future

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Creates another reason to consider purchasing a nonqualified deferred annuity now – to fund LTC in the future on a tax advantaged basis - along with all the other reasons to buy an annuity like tax deferral and protection features

The Pension Protection Act of 2006 created a new provision in the Internal Revenue Code allowing dollars from nonqualified deferred annuities to be exchanged, tax-free, into certain stand-alone, long-term care insurance (LTCi) policies. *IRC Sec. 1035(a)(3)*.

Now a client may use the cash value of their deferred annuity to fund the premium payments for a stand-alone LTCi policy through a tax-free exchange.

Imagine a scenario where a client has a deferred annuity with significant gains in it. Assume the policy has a contract value of $100,000, gain of $75,000 and cost basis of $25,000 and the client has just purchased an LTCi policy with an annual premium of $4,000.

Under the 1035 exchange rules, this client may request that their annuity carrier send a portion ($4,000) of their annuity contract value to the LTCi carrier to pay the annual premium. This movement of money would be classified as a tax-free partial exchange*, assuming the client fills out the appropriate exchange paperwork with the annuity carrier.

Partial exchanges from deferred annuities are done proportionately, meaning that a portion of the money that moves over to the LTCi product is gain and the other portion is basis, based on the ratio of gain-to-basis in the relinquishing contract. In our example the ratio of gain-to-basis is 75%/25%, so $3,000 of the exchanged amount is gain and $1,000 is cost basis, for a $4,000 total partial exchange amount.

With this scenario the client has used what would have been taxable gain in the annuity to fund a portion of the LTCi premium without having to pay income tax on that gain.

Every year thereafter, when the LTCi premium comes due, the client would submit partial exchange paperwork to the annuity provider to have an amount equivalent to the LTCi premium exchanged, taxfree, from the annuity to the LTCi provider to satisfy this premium obligation. The practical effect of this exchange is to turn a portion of the annuity’s taxable gain into potentially tax-free LTC benefits, assuming the owner qualifies for potential LTC benefits in the future.

This provision is the only place in section 1035 where taxable annuity gain may be turned into tax-free benefits. Because of this fact this new provision creates a powerful planning tool - fund current LTCi premiums with partial exchanges from annuities with significant gain.

This new rule also creates significant planning opportunities for the future when combined with the other features of nonqualified deferred annuities like tax deferral during accumulation, protection featuressuch as guaranteed lifetime withdrawals and death benefits, annuitization and probate avoidance if an individual, trust or charity is named beneficiary.

* In Notice 2011-68 the IRS recognized that partial exchanges from a deferred annuity to an LTCi policy are allowed. Also, the IRS provided guidance in Revenue Ruling 2003-76 regarding pro-rata treatment in a partial exchange between deferred annuities; and, while there is not direct guidance that pro-rata treatment on partial exchanges from deferred annuities to LTCi is permitted, it is generally accepted and practiced in the regular course of business.

Please be aware that investing involves risk of loss, the client may lose value, and specific rates of return are not guaranteed and that withdrawals during life may reduce any death benefit guarantees.

If you decide to take your money out early from a nonqualified deferred annuity, you may face fees called surrender charges. Plus, if you're not yet age 59½, you may also have to pay an additional 10% tax penalty on top of ordinary income taxes on withdrawals of gain.

This material is not a recommendation to buy or sell a financial product or to adopt an investment strategy. Investors should discuss their specific situation with their financial professional.

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