

# Could a 1035 tax-free exchange help cover LTC insurance costs?

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No estate plan is complete without considering long-term care ("LTC") expenses and how to pay for them. LTC insurance is an option, but these policies can be expensive. One solution is to use a total or partial tax-free exchange of an existing life insurance policy or annuity contract.

## Reviewing the history

For many years, Internal Revenue Code Section 1035 has permitted taxpayers to exchange one life insurance policy for another, one annuity contract for another, or a life insurance policy for an annuity contract without recognizing any taxable gain.

In the late 1990s, the U.S. Tax Court approved *partial* tax-free exchanges. A partial exchange might involve using a portion of an annuity's balance or a life insurance policy's cash value to fund a new contract or policy. For the transaction to be tax-free, the exchange must involve a *direct* transfer of funds from one carrier to another.

The Pension Protection Act of 2006 expanded Section 1035 to include LTC policies. So now it's possible to make a total or partial tax-free exchange of a life insurance policy or annuity contract for an LTC policy (as well as one LTC policy for another).

## Funding LTC costs

Partial tax-free exchanges can work well for standalone LTC policies, which generally require annual premium payments and prohibit prepayment. A partial tax-free exchange not only provides a source of funds for LTC coverage but also offers significant tax benefits.

Ordinarily, if the value of a life insurance policy or annuity contract exceeds your basis, lifetime distributions include a combination of taxable gain and nontaxable return of basis. A partial tax-free exchange allows you to defer taxable gain and, to the extent the gain is absorbed by LTC insurance premiums, eliminate it permanently.

If you're concerned that LTC costs might deplete your funds, thereby allowing less wealth to pass to heirs, please contact us. We can help you determine whether one of these strategies may be an option for you.

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