How to fund long-term care insurance with a tax-free exchange

For many people, the possibility that they'll incur significant long-term care ("LTC") expenses is one of the biggest threats to their estate plans. These expenses — for nursing home stays, assisted-living facilities, home health aides and other care — can quickly deplete funds you've set aside for retirement or to provide for your family.

One of the most effective ways to defray these costs is by purchasing LTC insurance. But LTC insurance also is a major expense, especially for someone who purchases it at or after retirement age. One potential source for funding LTC insurance premiums is a total or partial tax-free exchange of an existing life insurance policy or annuity contract.

A glance at exchanges

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. (Sec. 1035 doesn't permit an exchange of an annuity contract for a life insurance policy.)

In the late 1990s, the U.S. Tax Court approved *partial* tax-free exchanges, finding that these exchanges satisfy the requirements of Sec. 1035. 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. In order 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 Sec. 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). Keep in mind that, to avoid negative tax consequences after making a partial exchange of an annuity contract for an LTC policy, you must wait at least 180 days before taking any distributions from the annuity.

Benefits for LTC funding

A tax-free exchange provides a source of funds for LTC coverage and 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 tax-free exchange allows you to defer taxable gain and, to the extent the gain is absorbed by LTC insurance premiums, eliminate it permanently.

Consider this example:

Tony, age 75, is concerned about possible LTC expenses and plans to purchase an LTC insurance policy with a premium of $10,000 per year. He owns a nonqualified annuity (that is, an annuity that's not part of a qualified retirement plan) with a value of $250,000 and a basis of $150,000 and wishes to use a portion of the annuity funds to pay the LTC premiums. Under the annuity tax rules, distributions are treated as "income first." In other words, the first $100,000 Tony withdraws will be fully taxable and then any additional withdrawals will be treated as a nontaxable return of basis.

To avoid taxable gain, Tony uses partial tax-free exchanges to fund the $10,000 annual premium payments. In an exchange, each distribution includes taxable gain and basis in the same proportions as the annuity: In this case, the gain is ($100,000/$250,000) × $10,000 = $4,000. Thus, each partial exchange used to pay LTC premiums permanently eliminates $4,000 in taxable gain.

Partial tax-free exchanges can work well for standalone LTC policies, which generally require annual premium payments and prohibit prepayment. Another option is a policy that combines the benefits of LTC coverage with the benefits of a life insurance policy or an annuity.

Typically, with these "combo policies," the death or annuity benefits are reduced to the extent the policy pays for LTC expenses. Often, premiums on these policies can be paid in a lump sum, in which case a total tax-free exchange of an existing life insurance policy or annuity contract may be appropriate.

In an exchange for a combo policy, any gains used to fund LTC premiums will permanently avoid tax. But gains that become part of the policy's cash value or are used to fund annuity payments may eventually be taxed.

Weigh your options

LTC insurance may be an effective way to protect your nest egg against LTC expenses and preserve it for the next generation. A tax-free exchange may be a cost-efficient strategy for funding LTC premiums. To determine whether this strategy is right for you, compare the costs, benefits and tax implications of various LTC insurance options, and assess the impact on benefits under the policy or annuity being exchanged.

The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com