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American
PRIVATE WEALTH®

Use Your Annuity to Pay for Long-Term Care Insurance

Generally, to be considered a tax-free exchange rather than a taxable surrender, you cannot receive the annuity proceeds directly--the proceeds from the annuity must be paid directly to the long-term care insurance company. Also, Section 1035 applies only if both the annuity contract and the long-term care insurance policy are owned by the same person or persons.

A complete statement of coverage, including exclusions, exceptions, and limitations, is found only in the long-term care policy. It should be noted that carriers have the discretion to raise their rates and remove their products from the marketplace.

The cost of long-term care can quickly deplete your savings and affect the quality of life for you and your family. Long-term care insurance allows you to share that cost with an insurance company. But premiums for long-term care insurance can be expensive, and cash or income to cover those premiums may not be readily available. One option is to exchange your annuity contract for a long-term care insurance policy.

Section 1035 exchange

Generally, withdrawals from a nonqualified deferred annuity (premiums paid with after-tax dollars) are considered to come first from earnings, then from your investment (premiums paid) in the contract. The earnings portion of the withdrawal is treated as income to the annuity owner, subject to ordinary income taxes. IRC Section 1035 allows you to exchange one annuity for another without any immediate tax consequences, as long as certain requirements are met. However, prior to 2010, an annuity couldn't be exchanged for a long-term care insurance policy on a tax-free basis. But the Pension Protection Act (PPA) changed that and, as of January 1, 2010, both life insurance and annuities may be exchanged, tax free, for qualified long-term care insurance.

Conditions for tax-free exchange

In order for the transfer of the annuity to the long-term care insurance policy to be treated as a tax-free exchange, certain conditions must be met:

- The annuity must be nonqualified, meaning it cannot be part of an employer-sponsored retirement plan. For example, a tax-sheltered annuity or an annuity used to fund an IRA would not qualify for tax-free exchange treatment.
- The long-term care insurance policy must meet the requirements of the Health Insurance Portability and Accountability Act (HIPPA) and IRS criteria. Generally, the long-term care insurance policy must provide coverage only for qualified long-term care services; it must be guaranteed renewable; it cannot have a cash surrender value; refunds or dividends can only be used to reduce future premiums; and policy benefits cannot pay for expenses covered by Medicare (except where Medicare is a secondary payee).
- The exchange must be made directly from the annuity issuer to the long-term care insurance company. You will not receive tax-free treatment if you withdraw funds from the annuity directly, then use them to pay the long-term care insurance premium.

Presuming these criteria are met, exchanging an annuity for a long-term care policy can be done in one of two ways: a full transfer of the entire cash surrender value of the annuity in exchange for the long-term care insurance policy; or partial exchanges of the annuity's cash value for the long-term care policy. Not all insurance companies allow long-term care policies to be funded with a single, lump-sum payment, so the more common approach may be to pay long-term care insurance premiums through several partial exchanges from the annuity.

Potential tax advantages

Exchanging your nonqualified deferred annuity for a long-term care insurance policy may have several tax-related advantages. You can use annuity earnings to pay for long-term care insurance without paying income tax on those earnings. This allows you to use otherwise taxable annuity earnings in a more tax-efficient manner.

According to the IRS, Section 1035 exchanges from a nonqualified annuity to pay for tax-qualified long-term care insurance are pro-rated based on the comparative percentages of principal and earnings in the annuity. For example, say you have a nonqualified annuity worth $100,000, which includes your premium of $50,000, plus earnings worth $50,000, and you haven't taken any previous withdrawals. You direct the annuity issuer to send $2,500 to the long-term care insurance carrier as a partial exchange to pay for insurance premiums. Your

Generally, IRC Section 1035 allows tax-free exchanges in the following circumstances:

- ***An annuity contract for an annuity contract***
- ***A life insurance policy for an annuity contract***
- ***An endowment contract for an annuity contract***
- ***A life insurance policy for a life insurance contract***
- ***A life insurance policy for an endowment contract***
- ***An endowment policy for an endowment contract (with special requirements)***
- ***A life insurance policy, endowment contract, annuity, or qualified long-term care policy for a qualified long-term care contract***

annuity cash value is reduced by $2,500, but half of that amount ($1,250) comes from earnings. As a result, not only have you withdrawn annuity earnings ($1,250) without paying taxes on them, but you have further reduced the taxable portion of your annuity by $1,250. By withdrawing earnings from your annuity to pay for long-term care insurance, you could reduce the taxable portion of your annuity, which can be important if you surrender the annuity later.

Another advantage relates to the long-term care insurance policy. Generally, a qualified long-term care insurance policy is treated as an accident and health insurance contract, and the benefits are typically treated as tax free, subject to certain limits. In this way, you may be able to use tax-free annuity earnings to pay for tax-free long-term care benefits.

Other possible benefits

Aside from the favorable tax treatment, there may be other benefits as well.

- Using an annuity to pay for long-term care insurance may lessen the need to tap other savings or income to pay for premiums.
- You may still use any remaining cash surrender value of the annuity for other income needs or expenses.
- Exchanging the annuity for long-term care insurance may better meet your current needs, financial situation, and preferences.

Some potential disadvantages

There are also some potential disadvantages to exchanging an annuity for long-term care insurance.

- Annuity surrender charges might be incurred on the exchange of the annuity, thus reducing the annuity's value.
- Reducing the annuity's value to pay for long-term care insurance premiums may reduce your ability to use the annuity to provide income needed in the future.
- Some nonqualified deferred annuities might not be eligible for a partial Section 1035 exchange because the annuity contracts may not allow annuity payments to be made to other than the annuity owner (e.g., annuity payments cannot be assigned to another payee).
- If you exchange the annuity for a long-term care insurance policy, your survivors won't have the annuity's cash value for income or savings that otherwise would have been available at your death.
- Generally, premiums for qualified long-term care insurance are deductible as qualified medical expenses subject to certain restrictions. The tax savings of using a tax-free Section 1035 exchange needs to be compared to available federal or state income tax deductions for long-term care insurance premiums. Depending on your situation, it might be more beneficial to deduct premiums and include annuity earnings as taxable income.

Frequently asked questions

If I am the sole owner of the annuity, can I exchange it for a long-term care insurance policy jointly owned by my spouse and me?

Generally, no, because the owners of both the annuity and the long-term care insurance policy must be the same. However, you may be able to change the ownership of your annuity to include your spouse. While changing ownership of an annuity is generally treated as a taxable event to the extent of gain (earnings) in the annuity, ownership changes between spouses are typically tax free, but be sure to consult your tax or financial professional before making ownership changes to your annuity.

I'm receiving payments from a nonqualified immediate annuity. Can I exchange these payments for long-term care insurance?

You may be able to assign the payments directly to the long-term care insurance company as a 1035 exchange, but the annuity payee must be the long-term care insurance company--if you're listed as the payee, payments will not receive tax-free treatment. Also, be aware that if long-term care insurance premiums increase, the annuity payments may not be sufficient to cover the cost of the long-term care insurance premiums. Also, if the annuity payment exceeds the insurance premium, you may be able to split the annuity payment, where an amount equal to the insurance premium is sent to the long-term care insurance company and the balance of the annuity payment is sent to you, but this would be at the discretion of the annuity issuer.

Can I use more than one annuity to pay for long-term care insurance?

Generally, yes, because funds from one or more nonqualified annuities can be exchanged for a long-term care insurance policy.