Using an Index Annuity to Pay for LTCI

Is your client looking to protect their future from an unexpected long term care event? Long term care insurance (LTCI) may be the answer, but what is the best way to pay the premiums? There are a lot of options, but some are more tax efficient than others.

One approach your client may want to consider is paying the premiums with annual partial 1035 exchanges from a non-qualified deferred annuity. The Internal Revenue Code permits these exchanges, which can be made on a tax-free basis.

Your client also may have cash set aside in a CD or money market account that is earning little interest. They could consider using these funds to buy the annuity, which in turn could fund their LTCI. Or they may own deferred annuities with gain, or perhaps permanent life insurance policies[1] with gain that they no longer have an insurable need for (their kids are grown up, their mortgage is paid off, etc.). If those policies or annuities are out of surrender and with an insurer that doesn't allow partial tax-free exchanges to pay LTCI premiums, it may be worth considering exchanging one or more for a deferred annuity that does.[2]

Encourage your clients to spend some time with you and their tax professional to review their current insurance needs and explore whether one of these tax-efficient methods to pay their long term care insurance premiums might make sense for them.

The Client

Joe, a 60-year-old male, recently approached his agent, Tom, about his need to protect himself from an unexpected health event in the future. After determining that Joe did not want to "self-insure," Tom suggested that he consider purchasing an LTCI policy. The premiums for an individual LTCI policy that provided the benefits Joe needed cost approximately $3,000 per year. Although Joe had over $1 million in net worth, he told Tom that he would like to find a way to fund all or a portion of his annual LTCI premiums in a way that was both tax efficient and limited the impact to his annual cash flow. Joe had already learned from his accountant that he could not deduct any of his premiums on his federal income tax return. During their conversation, Joe mentioned that he had a small whole life insurance policy totaling $73,000 in cash value with a $100,000 death benefit that he no longer needed. He told Tom that he would like to put that money to use elsewhere but was concerned about the $48,000 of taxable gain if he surrendered the policy.

The Strategy

Tom took the opportunity to walk Joe through a funding strategy that would allow him to get the LTCI coverage he needed using the old policy. This strategy would also greatly reduce how much of the $48,000 in gain would be taxable. After their discussion, Joe applied for and was approved for a Genworth individual LTCI policy with an annual premium of $3,000. He paid the first annual premium out of pocket. At the same time, he applied for a Genworth SecureLiving® Fixed Indexed Annuity with optional Income Protection rider and funded the contract with a full 1035 tax-free

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[1] It is important to understand that life insurance policies may have too much cash value to be fully exchanged for a traditional long term care insurance policy, and a partial exchange (if allowed by the transferring company) may have adverse consequences on the life insurance policy. One alternative may be to fully exchange the life insurance policy for an annuity and then do partial exchanges from the annuity to fund long term care insurance premiums. Another alternative may be to exchange the life insurance policy for a linked benefit product.

[2] Prior to engaging in a 1035 exchange, your clients should carefully consider a number of factors, including the features and crediting rate(s) of their current product, applicable surrender charges, any new surrender charge period on the purchase of a new product, as well as the various features and crediting rate(s) of the new product. Representatives should carefully consider whether a replacement is in the best interest of their client before making a recommendation to replace the client's existing product.

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exchange from his whole life policy. $73,000 came over to a SecureLiving Index annuity contract with the optional Income Protection rider,[3] of which $48,000 was taxable gain and $25,000 cost basis.

After one year, Joe began his lifetime withdrawal income provided by the annuity and optional rider. Based on his age, he would receive $3,689 each year for the rest of his life. This is more than enough to cover his initial annual long term care insurance premiums and gives him an additional $689 in annual cash flow. Tom and Joe have set it up so that $3,000 of each of Joe's payments is sent as a partial 1035 exchange to pay his LTCI premium.[4] At the time of his first payment, the annuity contract value had grown to $75,000, which gave him a ratio of approximately 1/3 cost basis and 2/3 gain in his contract. That same ratio (exclusion ratio) is applied to the $3,000 premium going to the LTCI policy ($1,000 is basis, $2,000 is gain). Had Joe taken the $3,000 as a normal annuity withdrawal, all of it would have been taxed to him. Instead, with this premium funding strategy, the gain transferred out of Joe's annuity to fund his LTCI premium isn't taxed.

Joe takes a distribution of the additional $689 above what was needed to pay his policy premium. The entire $689 is taxable income to Joe. It is taxed under the normal rules for withdrawals from a deferred annuity: gain first, basis second.

The annuity contract now has $71,311 of contract value, and of the $71,311 there is $24,000 of cost basis ($25,000 minus $1,000) and $47,311 of gain.

Each year a partial 1035 exchange is automatically taken from Joe's annuity to fund his LTCI policy, and a new determination is made as to what the basis/gain ratio is at the time of exchange. The underlying index annuity contract is then adjusted accordingly. Over a number of years, much of the taxable amount Joe brought to this annuity may be eliminated through his annual partial exchange that pays his LTCI premiums.

[3] An annual charge of 0.95% for the Income Protection rider, based on the benefit base, is deducted annually from the contract value and the minimum guaranteed surrender value at the end of each contract year (state variations apply).

[4] It is important to understand that LTCI premiums may increase over time and the guaranteed withdrawal income payment, free withdrawal amount or annuitized payment may no longer be sufficient to cover the cost of the LTCI policy. You should consider your ability to cover an increased premium payment over time should your long term care insurance premium increase.

Is this Strategy right for everyone?

For your clients who need long term care insurance, they should consider the most affordable, convenient and tax-efficient strategies available to them. Each customer's circumstances are different, so there is no one-size-fits-all approach.

Other strategies may offer more convenience or better tax efficiency, depending on a client's situation. For example, a client's LTCI premiums might be paid by a third party, such as a family member or employer, thus creating no out-of-pocket cost or tax liability for the client. Other clients may be able to deduct all or part of their premiums as personal itemized medical expenses (individuals) or above-the-line adjustments to income (self-employed). Still others may be able to pay some or all of their premiums in a tax-efficient manner through an HSA, HRA or MSA, or from their pension plan if they are a qualified retired public safety officer. If another tax-efficient method is available to your client, compare the value of that method to using an annuity — it may or may not offer better results.

Which of your clients might be interested in the 1035 exchange strategy?

1. Those who have a need for or already have traditional LTCI
2. Clients with available cash to purchase a new deferred annuity
3. Those with existing cash value life insurance that isn't needed, or an existing non-qualified deferred annuity that doesn't allow for partial exchanges to LTCI (such policy(ies) or contract(s) must be suitable for exchange to a new Genworth deferred annuity)
4. Clients who do not have a better alternative to pay their premiums, considering cost, convenience and tax efficiency
5. Clients who may have a need for both guaranteed income and funding of LTCI premium payments

Other Important Considerations:

- Annual partial 1035 exchanges are generally allowed
- Genworth allows exchanges from Fixed Indexed Annuities (FIA) both with and without the income rider
- FIA must be non-qualified

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- LTCI policy must be tax-qualified
- Owner(s) on FIA have to exactly match owner(s) of LTCI policy
- Genworth does not require exact match of annuitant(s) to insured(s)
- Partial 1035 exchanges can't begin less than 12 months from annuity issue due to contract restrictions
- Partial 1035 exchanges should be done on annual basis
- If an important reason for buying the annuity is to pay LTCI, then LTCI policy needs to be in place prior to FIA application
- Once the annuity is issued, use exchange Form 42923-LTC and send it to LTCI policy services
- LTCI premiums may increase over time, and the guaranteed withdrawal income payment, free withdrawal amount or annuitized payment may no longer be sufficient to cover the cost of the LTCI policy. You should consider your ability to cover an increased premium payment over time should your long term care insurance premium increase.
- Policyholder can elect for partial 1035 exchanges to occur each year without an additional request by simply checking a box on the exchange form. The partial 1035 exchange amount has to stay within the 10% free withdrawal amount during the surrender charge period to avoid surrender charges
- Partial 1035 exchanges to fund LTCI are permitted from all Genworth fixed rate and index deferred annuity contracts, including the FIA without the optional Income Protection rider
- If the strategy is accomplished using guaranteed withdrawals from the Income Protection rider, the partial 1035 exchange amount needs to stay within the withdrawal limit amount to avoid negative impact on the rider benefit base
- If the LTCI premium amount exceeds the withdrawal limit, it may be beneficial to pay the difference from another source to avoid negative impacts on the rider
- If the LTCI premium amount is less than the withdrawal limit, then any difference would be taken as a partial withdrawal (taxed gain first)
- For all partial 1035s in the strategy, there is a pro-rata allocation of basis/gain on the annual exchanged amount

SecureLiving® Index Annuities issued by Genworth Life and Annuity Insurance Company, Richmond, VA

SecureLiving® Index Annuities individual single premium fixed deferred annuity with market value adjustment and optional indexed interest crediting issued by Genworth Life and Annuity Insurance Company, policy form series GA3005-1113, GA3006-1113, GA303R-1113, ICC14GA3005 and ICC14GA303R et al. Products and/or riders may not be available in all states or markets. Features and benefits may also vary by state or market.

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Withdrawals may be taxable, and a 10% federal penalty may apply to withdrawals taken before age 59½. There is no additional tax deferral benefit for annuities purchased in an IRA, or any other tax-qualified plan, since these plans are already afforded tax-deferred status. The other benefits and costs should be carefully considered before purchasing an annuity in a tax-qualified plan.

This is a brief product description. Consult the annuity contract for a detailed description of benefits, limitations and restrictions. The contract terms and provisions will prevail.

Although the contract value may be affected by the performance of an index, the contract is not a security and does not directly or indirectly participate in any stock or equity investment, including, but not limited to, any dividend payment attributable to any such stock or equity investment.

The optional Income Protection rider is available for an annual charge of 0.95% based on the benefit base and deducted annually from the contract value and the minimum guaranteed surrender value in arrears (state variations apply).

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