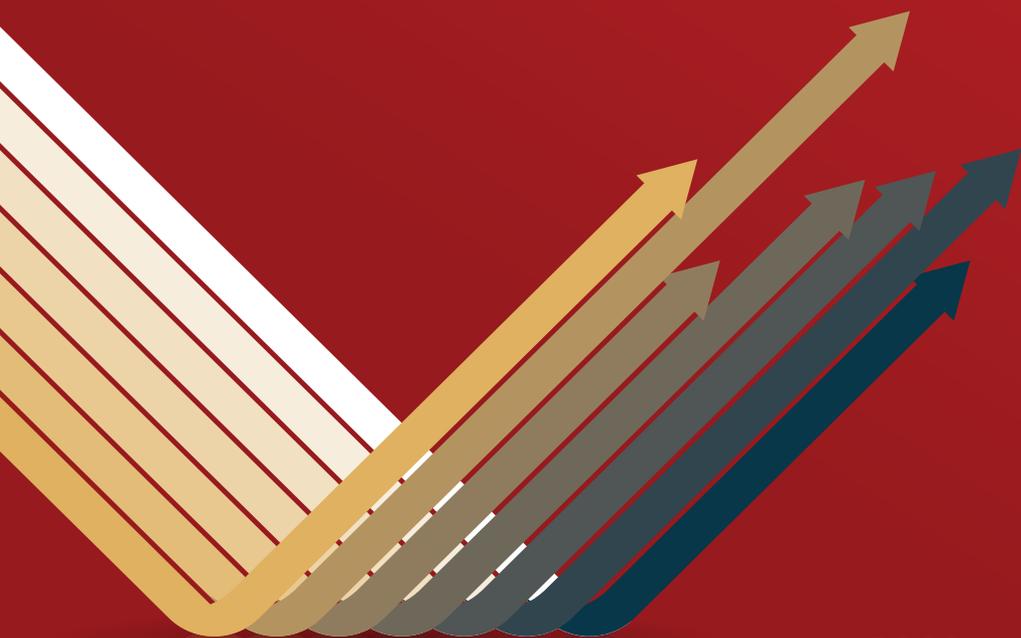


*American Association*  
for Long-Term Care Insurance

# GUIDE TO

## LONG-TERM CARE PLANNING USING 1035 EXCHANGES

A TAX-ADVANTAGED WAY TO REPURPOSE  
EXISTING ANNUITIES & LIFE INSURANCE



2018  
EDITION

# Who

## Should Read This Guide?

### **INDIVIDUALS WHO HAVE AN ANNUITY OR A LIFE INSURANCE POLICY**

### **INDIVIDUALS WHO ARE INTERESTED IN TAX-ADVANTAGED WAYS TO PLAN FOR LONG-TERM CARE NEEDS**

Millions of Americans have annuities or life insurance policies.

Yet few are familiar with Section 1035 of the Internal Revenue Code, which allows an individual to repurpose an existing annuity contract or life insurance policy to include tax-advantaged LTC benefits.

This guide explains how 1035 exchanges work and how they may benefit you. We believe you'll find the information of real value.

*Jesse Slome, Executive Director  
American Association for Long-Term Care Insurance*

### **Please note**

We believe plain-English information is what people want. This content is provided for overview and informational purposes only and is not intended as tax, legal, fiduciary, or investment advice.

# What's Inside



## The Basics

This section includes an overview of the Pension Protection Act (PPA). You'll learn how a 1035 exchange lets you convert an existing annuity contract or life insurance policy to one that also offers tax-advantaged long-term care (LTC) benefits.

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## 1035 Exchanges and Annuities

Millions of Americans include annuities in their retirement strategy. Discover the tax advantages of qualifying annuities that offer LTC benefits, and see examples of 1035 exchanges of annuities.

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## 1035 Exchanges and Life Insurance

American taxpayers are encouraged to purchase LTC protection in ways that differ from traditional standalone, health-based LTC insurance. For example, life insurance and LTC benefits can be combined in one policy. This section compares traditional life insurance with policies that combine life and LTC benefits.

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# The Basics

The Section 1035 Exchange provides a powerful, **tax-advantaged way to repurpose** an existing annuity or life insurance policy to one that **also provides LTC benefits.**

#### DISCLAIMER

Individuals in scenarios included in this guide are fictitious and numeric examples are hypothetical. Examples are used for explanatory purposes only based on real policies offered by leading national insurance companies (as of December 2017). Numbers shown have been rounded.

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# Section 1035 Exchange Basics

The Pension Protection Act (PPA) allows a 1035 exchange of an existing annuity or life insurance contract for a new one that includes tax-advantaged LTC benefits. The exchange must be made according to specific Internal Revenue Code and IRS regulations.

The PPA was passed by Congress in 2006 and became law in 2010. The act encourages individuals to buy LTC insurance by providing tax advantages to those who exchange existing annuities or life insurance for linked-benefit annuity contracts or life policies that also provide LTC benefits.

The PPA allows individuals to plan for future needs and take advantage of tax incentives to purchase LTC protection. A solution is to convert a tax-deferred annuity contract or life insurance policy into a tax-free asset to pay for qualifying LTC costs.

## FREQUENTLY ASKED QUESTIONS

### Does my current company have to let me exchange my contract or policy to another insurer?

Yes. Companies are legally bound, though they may be slow to respond. Issues may arise when 1035s are requested or processed. Be sure to work with an experienced and knowledgeable professional to avoid delays and potential tax consequences.

### What about IRAs and other tax-qualified funds?

Section 1035 applies only to non-qualified funds. But some strategies allow rollovers (or direct transfers) to IRA annuities with tax-advantaged LTC benefits.

## Contracts that may be exchanged under §1035

Type of policy → to	Life insurance	Endowment	Annuity	LTC <sup>1</sup>
Life Insurance	Yes	Yes	Yes	Yes
Endowment	No	Yes <sup>2</sup>	Yes	Yes
Annuity	No	No	Yes	Yes
LTC <sup>1</sup>	No	No	No	Yes

<sup>1</sup> Contract must be "qualified" long-term care under IRC §7702B.

<sup>2</sup> This assumes payments begin no later than under the old contract.

# Benefits Beyond Traditional LTC

**Congress passed**  
the PPA to provide  
individuals **more tax-advantaged**  
**incentives** to plan for LTC.

**Linked-benefit LTC solutions**  
are annuity contracts and life insurance policies that include the  
benefits you'd expect, in addition to tax-free payments for  
qualifying LTC expenses.

**In 2016**, more than **three times**  
**as many individuals** purchased a  
linked-benefit LTC policy than traditional  
health-based LTC insurance.<sup>1</sup>



<sup>1</sup> Source: American Association for Long-Term Care Insurance, 2016 sales data

# Benefits of Linked-Benefit LTC Products

A primary advantage of a linked-benefit annuity contract or life insurance policy is that the consumer receives benefits even if he or she does not ever need LTC services.

## These benefits could include:

- **Premiums that never increase**
- **Benefits that never decrease**
- **Asset growth at guaranteed rates**
- **Access to funds if needed**
- **Death benefits if not used for LTC**
- **Return-of-premium options**
- **Lifetime LTC benefits**

Note: Provisions for linked-benefit contracts or policies vary based on the type of product (life or annuity), the insurance company and even by state.

**Linked-benefit fixed or indexed annuities** can provide LTC coverage. Before the PPA, annuity owners had to spend taxable gains before the principal could be used for tax-free purposes. Under the PPA, a qualifying annuity can pay for LTC costs without tax consequences.

**Life insurance with LTC benefits** can provide a death benefit, LTC protection or both. Under the PPA, a qualifying life + LTC policy allows the policyholder to use the death benefit as needed to pay for qualifying LTC costs. Any portion of the death benefit not used for LTC may be passed to beneficiaries.

## FREQUENTLY ASKED QUESTIONS

### Are linked-benefit LTC products something new?

No. This concept and some products have been available for more than 25 years. The PPA provides tax advantages and makes 1035 exchanges a valuable LTC planning option.

### Do linked-benefit LTC products provide broad coverage?

Yes. They can pay for home care, assisted living and adult day care, as well as nursing home care. Benefit triggers are the same as traditional LTC insurance. To qualify, the individual must show the inability to perform at least two of six activities of daily living or require care due to severe cognitive impairment, such as Alzheimer's disease or dementia.

# Guide to 1035 Exchanges

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## Annuities

**Millions of Americans** include **fixed or indexed annuities** in their retirement strategy.

**A linked-benefit annuity** can help grow your assets, provide protection from market downturns and help pay for qualifying LTC expenses.

The PPA affords certain **tax advantages to qualifying linked-benefit annuities.**

# Benefits of Linked-Benefit LTC Products [Annuities]

Many individuals allocate some "just in case" dollars into fixed or indexed annuities to help protect retirement income. In fact, in 2016 the value of fixed and variable annuities exceeded \$2.8 trillion.

Source: U.S. Individual Annuity Yearbook, 2016 Data, LIMRA Secure Retirement Institute.

People use annuities to provide retirement income to last a lifetime, and for the knowledge that if funds are never needed (say for end-of-life care), they may pass to heirs.

And if a person needs LTC? He or she can use funds to pay for care, either by turning on the annuity income stream or making withdrawals. Both options may have tax implications.

Annuities that meet PPA provisions let owners withdraw proceeds for LTC coverage and/or income. Annuity owners can pay for qualifying LTC costs income tax-free. The flexibility and potential tax advantages are good reasons to consider repurposing an existing annuity.

## FREQUENTLY ASKED QUESTIONS

### When is a 1035 exchange of an annuity a good idea?

It's a good idea when it affords you tax advantages; for example, when you can purchase tax-free LTC benefits.

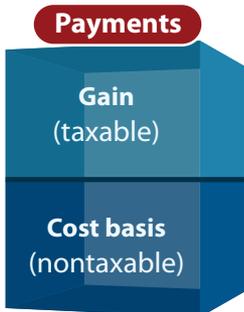
### Are partial exchanges allowed?

Maybe. Partial exchanges may be permitted with the gain, but the procedures may vary by insurance carrier.

### Does the PPA apply to qualified annuities?

No. Qualified annuities under an individual retirement account, such as Roth IRAs, SIMPLE, SEP or 403(b) annuities, do not qualify for PPA tax advantages.

Existing  
Nonqualified Annuity  
(with gain + cost basis)



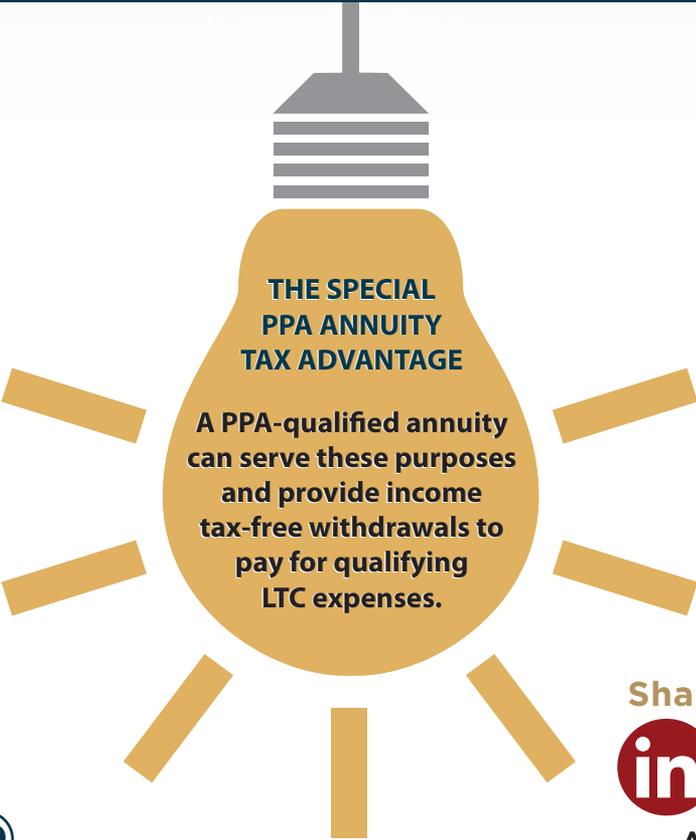
Section 1035  
Exchange

Linked-Benefit Annuity  
(payments for LTC  
expenses only)



# Individuals own annuities for many reasons.

Beyond the tax advantages and potential account growth, annuities can help serve as an emergency fund in case of a catastrophic illness or for in-home or nursing home care.



## THE SPECIAL PPA ANNUITY TAX ADVANTAGE

A PPA-qualified annuity can serve these purposes and provide income tax-free withdrawals to pay for qualifying LTC expenses.

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# Comparing Options Nonqualified Annuities

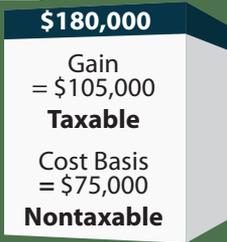
Let's look at a typical situation to compare the potential benefits of repurposing an existing nonqualified annuity at age 65.

For example, a 65-year-old individual owns a nonqualified annuity obtained at age 49. The cost basis is \$75,000 with an average annual return of 2.5% for a traditional annuity and 1.5% for a linked-benefit annuity. Values are projected to age 85, when the likelihood of needing LTC is greatest.

## USING YOUR TRADITIONAL ANNUITY

TO PAY FOR LTC EXPENSES [COSTS]

### BEFORE



Available amount for LTC costs at age 85

**\$180,000** (projected)

Accumulated value/cash surrender value (age 85)

**\$180,000** (projected)

Withdrawals to pay for qualifying LTC care  
36 months @ \$5,000/month (age 85)

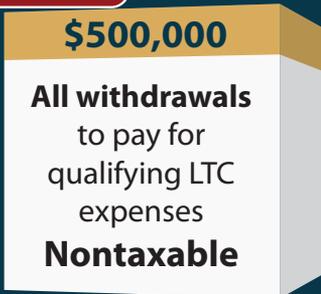
**\$105,000 SUBJECT TO INCOME TAXATION**

## USING A 1035 EXCHANGE TO REPURPOSE INTO A

PPA-QUALIFIED LINKED-BENEFIT ANNUITY

Annuity is repurposed at age 65, and the 1035 Exchange amount is \$110,000.

### AFTER 1035



Available amount for LTC costs at age 85

**\$500,000 - payable over 60 months total**

Payable at \$4,400 for first 24 months, then,

Payable at \$12,000 for next 36 months

Value at death if LTC is never needed = \$105,000

## ADVANTAGES OF LINKED-BENEFIT ANNUITIES

- ♦ Guaranteed, tax-deferred cash value growth.
- ♦ Tax-free LTC benefit payments.
- ♦ Assets that can be passed to beneficiaries.
- ♦ Optional lifetime protection.
- ♦ Benefits for owner and spouse.



# Who Should Consider Linked-Benefit Annuities?

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## Individuals who:

**Are generally between ages 50 and 85.**

**Have money set aside but have not found an attractive LTC insurance product.**

**Are not comfortable self-funding their LTC risk.**

**Are turned off by the "use it or lose it" nature of traditional health-based LTC insurance.**

**Are generally in good health.**

**Prefer an interest-based growth option to protect their estate, limit risk and maintain assets if they never need LTC.**



# Comparing Options

## Nonqualified Annuities

**How can one existing annuity be repurposed to secure lifetime LTC benefits for two spouses? Take a look.**

One spouse may own an annuity to pay for LTC. A downside is that a portion of any withdrawals are taxable as income. Perhaps more important, if one or both spouses need care for an extended time, the annuity value can be depleted, even when LTC benefits are still needed.

Some PPA-qualified annuities can provide access to "lifetime" or "unlimited" LTC benefits. Benefits can cover LTC costs for one spouse or for both. Withdrawals for LTC are not subject to income tax. And if neither spouse needs long-term care, the beneficiaries receive the annuity's full proceeds.

### USING YOUR TRADITIONAL ANNUITY TO PAY FOR LTC EXPENSES

**BEFORE**

**\$5,000**

Partially Taxable

**\$200,000 currently available in a nonqualified annuity**  
Annuity owner, age 66 and spouse, age 62

**Withdrawals of \$5,000/month to pay for LTC**

=

**Roughly 40 months of withdrawals**

Withdrawals are taxable to extent of gain

### USING A 1035 EXCHANGE TO REPURPOSE INTO A PPA-QUALIFIED LINKED-BENEFIT ANNUITY

**AFTER 1035**

**\$5,000**

Income Tax-Free

**\$200,000 exchanged to a linked-benefit annuity**  
Spouses, ages 66 and 62

**Withdrawals of \$5,000/month to pay for LTC**

=

**Lifetime (unlimited) - payments, income tax-free**

Suppose one spouse needs LTC for 24 months (2 years) and the other for 60 months (5 years). This linked-benefit annuity will pay income tax-free benefits of \$420,000.

If neither one needs LTC and the second spouse dies at age 94, the linked-benefit annuity pays the designated beneficiaries \$202,000.

# Guide to 1035 Exchanges Life Insurance

## **Time changes everything.**

The intended use of your **life insurance policy** may have changed. Maybe it's time to exchange your coverage for a product that **also provides LTC benefits.**

The PPA allows for leverage and tax benefits for qualifying **Life + LTC policies.**

One of consumers' main concerns about LTC planning is that they'll pay premiums but may never receive living benefits. Exchanging an existing life policy can resolve this concern.

# How to Repurpose Existing Life Insurance

**The IRS lets you exchange** an existing life policy for a new one that includes LTC benefits (that is, a Life + LTC policy) without paying taxes on realized gains.

**Consider these reasons for exchanging an existing life insurance policy:**

**Changing needs.** As you grow older, the reasons you purchase life insurance may change. You've probably thought about the risk that you'll need LTC one day, but you haven't acted.

**An attractive LTC planning option.**

Consumers balk at the "use it or lose it" nature of traditional LTC policies. A Life + LTC policy with a potential death benefit removes this concern. Plus, most offer guaranteed premiums which eliminates the risk of future premium increases.

**Better coverage and tax advantages.** Older policies likely don't include desired features, such as LTC benefits. The PPA lets you purchase these benefits tax free.

**Stronger insurance company.** If your policy has a significant cash value, you may want to transition it to a carrier with better ratings and financial stability.

## FREQUENTLY ASKED QUESTIONS

**How do Life + LTC policies work?**

LTC riders generally are attached to a base life insurance policy. If you need LTC, the base policy's death benefit is used to pay for qualifying claims. After the death benefit is fully used, a rider can extend LTC benefits for a specified time.

**Do these policies include any guarantees for consumers?**

Yes. Policy guarantees include a death benefit if not used for LTC benefits and the option to have your premiums returned. Premiums can be guaranteed not to increase, and assets may grow at a guaranteed rate.

**Do Life + LTC policies provide broad coverage?**

Yes. Just like traditional LTC insurance policies, these policies pay for qualifying home care, assisted living or skilled nursing facility care.

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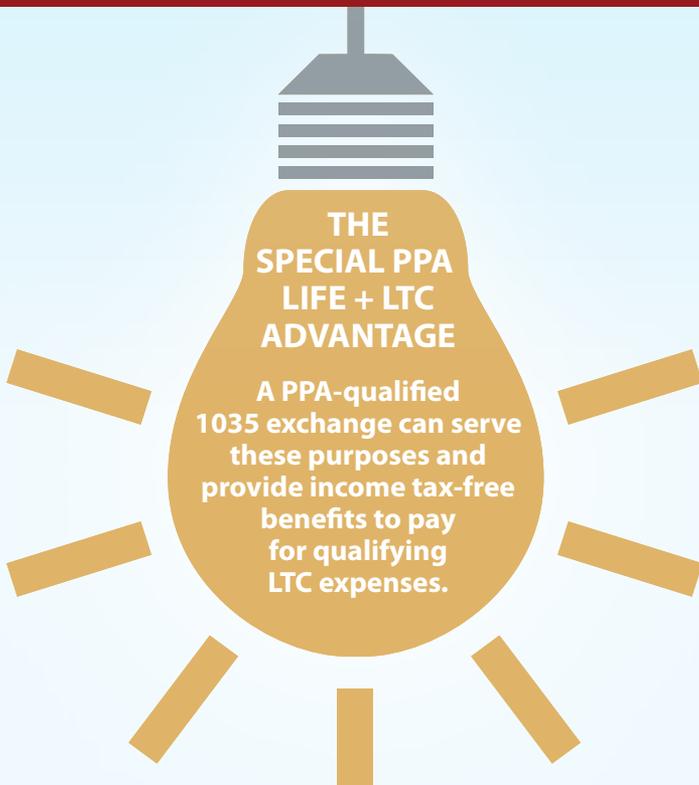
# Life + LTC Product Advantages

## “Use It - Get It - Give It” Scenarios

**Use It - Live a long life and chances are you'll need LTC. With a Life + LTC policy, you can typically access 100% of death benefits for qualifying LTC expenses.**

**Get It - You have the option to cancel a Life + LTC policy and get some or all of your premiums back.**

**Give It - Your Life + LTC policy provides a death benefit to your designated beneficiaries.**



# Comparing Options

## Leverage a Modest Life Policy for Significant LTC Benefits

A 1035 exchange of even a modest life insurance policy can maintain a death benefit while adding tax-free LTC benefits.

**Example:** A male, age 60, has a cash value life insurance policy worth \$75,000. The death benefit is no longer important to him. His chief concern now is not to burden his family with potential LTC costs, which he worries could grow and consume his nest egg.

### USING YOUR CASH VALUE LIFE INSURANCE POLICY TO PAY FOR LTC EXPENSES

BEFORE

Life insurance can help fund LTC costs in several ways – with potential tax consequences. And some policy values likely won't grow at the same pace as rising LTC costs.

### USING A 1035 EXCHANGE TO REPURPOSE INTO A LIFE + LTC PRODUCT

AFTER 1035

Age of LTC Claim (Lasting 22 months)	<u>Monthly LTC Benefit</u> <u>LTC Potential Benefits</u>	<u>Surrender</u> <u>Value</u>	<u>Death</u> <u>Value</u>
<b>Starts at age 70</b>	<u>\$3,600/month</u> <b>\$121,000</b>	<b>\$52,000</b>	<b>\$83,000</b>
<b>Starts at age 80</b>	<u>\$4,900/month</u> <b>\$163,000</b>	<b>\$63,000</b>	<b>\$83,000</b>
<b>Starts at age 90</b>	<u>\$6,200/month</u> <b>\$205,000</b>	<b>\$71,000</b>	<b>\$83,000</b>

The benefits paid for LTC are not subject to income tax.  
The monthly LTC benefit grows at 5 percent (simple) annually.

### ADVANTAGES OF LIFE + LTC POLICIES

LTC benefit amounts may be guaranteed (e.g., benefits will never decrease).

LTC benefits may be guaranteed for a lifetime, and premiums can be guaranteed never to increase.

Death benefits that are not used for LTC can pass to beneficiaries income tax-free.

Policy benefits are always governed by the individual policy provisions which may vary.



# Why Life + LTC Products Are Increasingly Popular

**Features, options and benefits may vary, but here are some reasons Life + LTC policies are increasingly attractive.**

**Premiums guaranteed to never increase.**

**Optional joint protection for spouse or other loved one.**

**You can select unlimited (lifetime) LTC benefits.**

**You can get coverage issued up to age 80, in most cases.**

**Payments for qualifying LTC can be made for the time period you choose.**

**Inflation options help protect against rising LTC costs.**

**You can get your premium back if you change your mind.**

**You can take policy loans or pass the death benefit to heirs if it's not used for LTC.**

NOTE: Policy provisions vary from one insurance company and policy to another and may not be available in all states. Consult with a knowledgeable insurance professional experienced in selling life + LTC policies.

# Comparing Options

## Traditional Life Insurance versus Life + LTC Policy

Let's look at another typical situation by comparing the potential benefits of repurposing an existing whole life insurance policy at age 66.

**Example:** A female, age 66, has a cash value life insurance policy worth \$150,000. She is retired and financially independent with grown children. She wants to leverage her policy's tax-advantaged growth to maximize the available tax-free LTC benefits.

AFTER 1035

### USING A 1035 EXCHANGE

TO REPURPOSE INTO A LIFE + LTC PRODUCT

Age of LTC Claim	Monthly LTC Benefit LTC Potential Benefits	Death Value
Starts at age 76	\$6,800/mo. for first 25 mos. then \$9,400/mo. for next 25 mos. \$400,000 Potential Benefits	\$170,000
Starts at age 91	\$6,800/mo. for first 25 mos. then \$14,700/mo. for next 25 mos. \$535,000 Potential Benefits	\$170,000

The guaranteed minimum interest rate is 4%.  
Benefits paid for LTC are not subject to income tax.  
The second 25 months of LTC coverage grows at 3%.

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# We Asked the 1035-Exchange Experts

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## **What are the advantages of using a linked-benefit product to fund LTC expenses?**

Some individuals can't get past the "use it or lose it" nature of traditional LTC insurance. Linked-benefit products that meet PPA provisions generally allow tax-free withdrawals to pay for qualified LTC expenses. Product riders typically provide an LTC benefit pool from two to three times the base premium amount.

## **Are all linked-benefit products pretty much the same?**

No. There can be a significant difference in the potential LTC benefit and/or the potential death benefit.

## **Do I have to exchange the entire amount of my contract or policy to get the 1035 exchange benefits?**

Partial exchanges of annuities may be permitted, but this will depend on the individual insurance company. Partial exchanges of life insurance are generally not permitted.

## **What types of annuities can be exchanged?**

Any nonqualified annuity may be used, subject to limitations set by the transferring insurance company.

## **Are annuity exchanges subject to a surrender penalty?**

To find the answer, work with a knowledgeable insurance agent or financial professional who can help you evaluate the new guaranteed rate, the added leverage and the tax advantages of LTC benefits.



**Can I exchange my life insurance policy or annuity contract by moving it from one company to another?**

Yes. Insurance companies are legally bound to honor a surrender request. Companies may be slow to process your request, but they must honor it. Be sure to use the correct 1035 exchange paperwork. Contracts or policies with irrevocable beneficiaries require sign-off before the exchange can be made.

**Can the policy or contract 'owner' be changed?**

The new policy/contract owner must be the same as the existing owner. You can, however, change ownership before or after the exchange. Talk with an expert to avoid issues with gifts, transfer value or gain recognition that could result from any policy ownership change.

**Are linked-benefit products medically underwritten?**

Generally, the answer is yes. But the health qualifications may be less stringent than traditional health-based LTC insurance. This is especially true for annuities.

**Is a 1035 exchange reported to the IRS?**

The insurance company typically requires a form with the surrendered funds. This enables them to report the surrendered amount as a nontaxable distribution on IRS Form 1099-R.

# Linked-Benefit Annuity Comparison Worksheet

	Policy #1	Policy #2	Policy #3
<b>Insurance Company</b>			
<b>Policy Name</b>			
<b>Company Rating (A.M. Best)</b>			
<b>1035 Exchange Amount</b>			
<b>Initial LTC Benefit Balance (Total)</b>			
<b>Initial Monthly Benefit</b>			
<b>Total LTC Benefit Period (Months)</b>			
<b>Continuation of Benefits Rider Period (Months)</b>			
<b>Surrender Value 5 Years 10 Years 20 Years</b>			
<b>LTC Waiting Period</b>			
<b>Benefits Paid (Reimbursement or Cash/Indemnity)</b>			
<b>Special Features (e.g. International facility coverage)</b>			
<b>Additional Access Options</b>			
<b>Inflation Growth Factor</b>			
<b>Monthly Benefit @ Age 85</b>			
<b>Medical Underwriting / Medical Exams</b>			
<b>Surrender Charges / Charges Waived</b>			

# Life + LTC Comparison Worksheet

	Policy #1	Policy #2	Policy #3
Insurance Company			
Policy Name			
Company Rating (A.M. Best)			
Guaranteed Minimum Interest Rate			
Initial Life Insurance Death Benefit			
Total LTC Benefit Balance Available			
Total LTC Benefit Period (Months)			
LTC Benefit Amount (Monthly/Daily)			
Surrender Value 5 Years 10 Years 20 Years			
Death Benefit 5 Years 10 Years 20 Years			
LTC Waiting Period			
Benefits Paid (Reimbursement or Cash/Indemnity)			
Special Features (e.g. International facility coverage)			
Additional Access Options			



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