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Tax-Favored, 1035 Exchange Long Term Care Insurance Premium Payments?

NOT YET!

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The Pension Protection Act (PL 109-280) [PPA], signed by, then, President Bush on August 17, 2006, includes very important provisions regarding qualified long term care insurance [LTCi]. These provisions took effect on January 1, 2010 and they could potentially revolutionize the LTCi industry by creating a tax-favored funding mechanism for this type of insurance.

However, despite the intent of the PPA of 2006, many questions still remain and most [disturbingly, not all] insurance companies are so concerned that they have opted to await further clarification from the Internal Revenue Service [IRS] before embarking on the large marketing and sales opportunities presented by the PPA.

So what are these important provisions of the PPA?

As of January 1, 2010, PPA established the tax-free 1035 exchanges (Internal Revenue Code (IRC) section 1035 exchanges) of life insurance, endowment, and annuity contracts for LTCi policies.

Further, most insurance companies believe this to include partial 1035 exchanges to pay the premium for new or existing LTCi policies.

Prior to January 1, 2010, the IRC did not allow tax-free 1035 exchanges for LTCi policies.

In other words, these provisions would not only allow for the tax-favored treatment of funding LTCi policies; they allow funding from already established funds amounting to trillions of dollars. Insurance companies welcomed these provisions as they saw an opportunity to recoup [by means of LTCi premiums] a significant portion of the distributions from life insurance, endowment, and annuity contracts.

Shortly after the enactment of the PPA, the insurance companies contacted the IRS for clarification on a number of issues but since these provisions were not to take effect until January 1, 2010, there was plenty of time on both the IRS' as well as the insurance companies' part. We are now three weeks into January, 2010 and the clarifications glare by their absence.

For the purpose of this article, I will exclusively describe the remaining issues surrounding the 1035 exchange from annuity contracts to LTCi policies since this particular transaction has been paid the most attention.

The issues and concerns that need clarification can be categorized into three:

Partial 1035 Exchange

Mr. Jones owns a deferred annuity contract from insurance company ABC. He wants to buy an LTCi policy from company XYZ and fund the premium by partial 1035 exchange from his annuity contract.

The first problem is that a 1035 exchange must be initiated for every premium that is due. For practical reasons, this excludes the option of paying the premium monthly and it will represent problems for quarterly, semi-annual and even annual premiums

The root of the problem is that insurance company ABC has no incentive to expedite the process and many annuity contracts allow for a 60-day period of the insurance company to release the funds.

If Mr. Jones is underwritten and approved for LTCi coverage, but

the funds are missing, the policy cannot take effect and Mr. Jones will have to be re-underwritten once the funds are made available.

Of course, Mr. Jones can just pay the premium from his regular checking account, but that somewhat defeats the whole purpose.

Assuming we somehow resolve these issues, we now find ourselves one year later, and the renewal premium is due. The process starts all over. The one difference is that instead of risking that the policy does not take effect, Mr. Jones now faces the potential of the policy lapsing if the premium is not made; remember, somebody needs to initiate each 1035 exchange. Who?

The insurance companies need to establish a process whereby partial exchanges can flow in an orderly manner. Such a clearing mechanism has not been established as the IRS has ruled neither for nor against proposed suggested guidelines put forth by the insurance industry.

[Full] 1035 Exchange directly to an LTCi Policy

Mr. Jones owns a deferred annuity contract from insurance company ABC. He wants to buy an LTCi policy from company XYZ and fund the premium by 1035 exchanging his annuity contract to the LTCi policy.

Initially, the easiest way to accomplish this is to 1035 exchange to a single-pay LTCi policy. Only a few insurance companies have such an option, and those who do, are conscious to make sure that such payment options only constitute a small portion of their portfolio. In other words, if a significant portion of LTCi sales represent single-pay policies such options will vanish.

Alternatively, this type of arrangement could be set up as a "period certain" or "for life" with or with out survivorship. These types of annuitizations would correspond to 10-pay or life-pay LTCi policies respectively. The problems surrounding these types of arrangements are to be found in the non-cancelable nature of LTCi policies. Specifically:

What happens if Mr. Jones wants to increase his coverage or if his policy is subject to a rate increase?

The increased premium needs to be split-billed as the distribution from the annuity only covers the original benefit. How does the LTCi insurance company account for [to the IRS] which portion of the premium originates from the annuity insurance company and which portion originates from the insured?

Currently, no LTCi insurance company provides for split-billing of individual LTCi policies.

What happens if Mr. Jones gets married and his premium is reduced due to the application of a spousal/marital/partner discount?

The annuity company is now distributing funds in excess of the LTCi premium due. To whom is that distribution paid and how is it taxed? If the excess distribution is made to the LTCi company how do they account for the "excess premium" and how do they "refund" the excess premium to the insured? Most importantly, how does Mr. Jones make sure that he files his tax-return appropriately to make sure he is taxed on the excess distribution?

Full 1035 Exchange to an LTCi policy by means of a SPIA

Mr. Jones 1035 exchanges his deferred annuity from insurance company ABC to a Single Premium Immediate Annuity [SPIA] with insurance company XYZ. The distribution from the SPIA funds the LTCi premium also issued by insurance company XYZ. This arrangement potentially alleviates many, if not most, of the issues previously listed. However, this "dual 1035 exchange arrangement" is still pending IRS guidance.

This type of arrangement using a SPIA as a conduit is heavily promoted by in particular one LTCi company, however most larger insurance companies have taken the prudent approach of awaiting IRS guidance despite the obvious marketing and sales opportunities.

In conclusion, the PPA allowed for significant tax-favored ways whereby annuity owners could funds LTCi premiums. However, before we recommend they do so, let's make sure we cross all the "Ts" as in Tax-advantages, and dot all the "Is" as LTC"I". These advantages will come soon enough to benefit us all, but until the IRS release their guidelines, let's not make our clients famous. "All good things come to he who waits."❖