Another Update on Using Cash Values from Life Insurance and Annuities to Pay LTC Premiums or Expenses (including Partial 1035 Exchanges)

Summary

Here is another update on using cash values from annuities and life insurance contracts – often tax-free – to pay premiums on LTC insurance.

Related Information

Update on Long-Term Care and 2010 – Combo Products, and Using Cash Values from Life and Annuity Contracts to Pay LTC Premiums or Expenses

Introduction: As we've discussed before,[1] certain changes started in 2010 relating to long-term care (LTC) insurance. It's time for another update, as the I.R.S. has issued relevance guidance since our last article.

What changed in 2010 (and still is in effect today): The changes that went into effect in 2010 are largely due to provisions of the Pension Protection Act (PPA) of 2006, and they generally involve two areas: combo products and § 1035 exchanges.

1. *Combo products*. These are products that combine life insurance with LTC insurance, or combine an annuity with LTC insurance.[2] To get the treatment described here,[3] the combo product has to be part of a life or annuity contract that was issued after December 31, 1996.

    a. Pulling money from the cash value of the life or annuity portion of the combo product to pay LTC premium on that combo product (*i.e.*, to pay for LTC coverage) comes first from tax-free basis. So this really only changes the ordering rule for annuities and modified endowment contracts (MECs).

    b. Here's the gem. After all the basis is used up/exhausted, further withdrawals from the cash value of the life or annuity portion to pay LTC premium on that combo product *are still tax-free, even though they're from the "gain" portion of the cash value*. But if there's a withdrawal from the gain portion for a reason other than paying for LTC coverage on this combo product, then it is income taxed pursuant to normal rules.

[1] See Update on Long-Term Care and 2010 – Combo Products, and Using Cash Values from Life and Annuity Contracts to Pay LTC Premiums or Expenses, *Advanced Planning Bulletin*, December 2009.

[2] Another colloquial name for a combo product is a "linked benefits" contract.

[3] § 72(e)(11).

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c. As for what happens when the insured ultimately receives LTC benefits from this combo product (e.g., he needs nursing care), that was not covered by PPA 2006, but was addressed by the I.R.S. in a private letter ruling. It held that the LTC benefit payments are tax-free pursuant to the normal rules under § 7702B(a)(2) and 104(a)(3), *but these payments reduce the investment in the contract of the related life or annuity contract*.[4] This means that, if the policy owner later takes withdrawals from the cash value for reasons unrelated to LTC, he is more likely to trigger income taxation.

2. *1035 exchanges*. These changes come from a different statute than the one that addresses combos, deriving instead from amendments to § 1035 that took effect in 2010.

a. The Pension Protection Act of 2006 added LTC contracts[5] to the bottom of the § 1035 hierarchy. So carrying out tax-free 1035 exchanges is permitted:

i. from life insurance –
- to life insurance
- to annuities
- to LTC contracts (this was new in 2010), and

ii. from annuities –
- to annuities
- to LTC contracts (this was new in 2010).

Under this § 1035 hierarchy, a life/LTC combo product is treated as a life contract, and an annuity/LTC combo product is treated as an annuity.

b. The addition of LTC contracts to the bottom of the § 1035 hierarchy is only half the battle. For the exchange to be tax-free, all of the money leaving the life or annuity contract has to be "swallowed up" by the LTC contract or combo product immediately. So, if you are buying a stand-alone LTC contract, you'll likely be dealing with periodic LTC premiums that cannot accommodate the life or annuity contract's entire cash value in one shot. This means any 1035 exchanges will likely be done through a series of small *partial* exchanges from the life or annuity contract to pay LTC premiums as they become due.

c. The law generally allows partial exchanges, but the IRS has imposed certain restrictions on them so the partial exchange is not misused as a device to transfer gain from the annuity contract in order to reduce the tax on subsequent withdrawals. These restrictions

[4] Priv. Ltr. Rul. 2009-19-011 (February 2, 2009) (investment in the contract will not be reduced below zero). Because the ruling did not distinguish between LTC benefits paid from annuity values and from LTC insurance amounts, there is a question whether the investment in the contract would be reduced for benefits paid from LTC insurance amounts.

[5] This benefit is only available to LTC contracts that are "qualified" under § 7702B.

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have undergone several iterations and recent guidance has limited their impact significantly.[6]

d. In fact, in August 2011, the I.R.S. issued a Notice that explicitly approved of partial exchanges from nonqualified deferred annuities to pay premium on LTC contracts.[7] The Notice didn't address partial exchanges to LTC contracts from *life insurance* policies specifically, but because the underlying law of § 1035 is essentially the same for life insurance and annuities, partial exchanges from life policies should be allowed as well.

e. Given all this –

   i. The owner of an annuity or MEC who is hoping to avoid tax on gain probably would choose a partial exchange over a non-1035 (gain-first) withdrawal.

   ii. Although the reasons are not as obvious, the owner of a traditional life policy might prefer a partial exchange too. Both a § 1035 exchange and a normal withdrawal would be tax-free (at least up to basis for the withdrawal), but the partial exchange leaves more basis remaining in the life policy, which means more of the cash value can be tapped into tax-free for later withdrawals that are *not* part of any 1035 exchange. Of course, some might find that the administrative hassles of partial exchanges might lessen their appeal.

What's not changing: Beyond the realm of combo products or 1035 exchanges described above, the rules are basically the same now as they were before 2010.

So, if you have a life insurance or annuity contract that does not have an LTC rider (so it is not a combo product), and you pull money out in a way that's not a 1035 exchange (partial or otherwise), then that withdrawal will be just as taxable (or not taxable) as it has always been. *And this is true even if you use that money to pay LTC insurance premium and/or LTC expenses.*

But isn't there a way to withdraw cash values tax-free for LTC *expenses/services*? Some publicly available articles have given the impression that policy owners could, starting in 2010, withdraw cash values from life insurance or annuity contracts tax-free to pay for LTC *expenses or services* – that is, not even buy an LTC insurance contract, and simply use the cash values tax-free to pay the nursing home directly.

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[6] *See*, Rev. Proc. 2011- 38. To get a feel for the various changes, see our previous articles: Partial Exchange Rules for Annuities are Changed Yet Again (It's Relevant for Exchanges to LTC Insurance Too): Revenue Procedure 2011-38, 2011-30 I.R.B. (June 28, 2011), *Advanced Planning Bulletin*, July 2011; Good News for Partial Exchanges and Partial Annuitizations, *Advanced Planning Bulletin*, October 2010; Don't Believe Anything You Hear – I.R.S. Changes its Tune on Partial Exchanges of Annuity Contracts Under Revenue Procedure 2008-24, 2008-13 I.R.B. 1 (March 13, 2008), *Advanced Planning Bulletin*, July 2008; and I.R.S. Revises Guidance on Partial Exchanges of Annuity Contracts – Some Good, Some Bad, and Some Unknown: Revenue Procedure 2008-24, 2008-13 I.R.B. 1 (March 13, 2008), *Advanced Planning Bulletin*, April 2008.

[7] Notice 2011-68, 2011-36 I.R.B. The guidance assumes that the restrictions of Rev. Proc. 2011-38 apply but leaves several other questions unanswered. One issue that is not specifically addressed is whether the general pro rata basis carryover rule of Rev. Rul. 2003-76 – that basis and gain are carried over to the new contract in the same proportion as the cash value exchanged – will be applied to exchanges to LTC contracts. It is anticipated that additional guidance will be issued.

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That's just not true.

1. It seems that proponents of this view are thinking of combo products, most of which are designed so that part of the LTC benefits paid depletes the cash values of the related life or annuity contract. In some sense, then, because the LTC benefits are received tax-free under normal rules, and because they reduce cash values simultaneously, this might be described as using the life policy's or annuity contract's cash value to pay for LTC expenses tax-free. But to get this tax-free treatment for the LTC benefits, the LTC component of the combo contract still must separately qualify as LTC "insurance."[8]

2. Clearly then, there still must first be an LTC contract – here, as part of a combo product – so it's still not the case that, starting in 2010, a policy owner can simply take withdrawals from the cash value of a stand-alone life insurance or annuity contract and claim that they are tax-free solely because they're paying LTC expenses or services. If the withdrawals are tax-free, they are so because of normal tax rules – e.g., tax-free up to basis for life insurance – but that'd be just as true if the withdrawn cash were instead used to buy a car, a boat, or whatever.[9]

Conclusion: Tax advisors should make themselves familiar with the rules governing combo products and partial § 1035 exchanges to pay LTC premiums. Doing so will enable them to help their clients make the best decisions when it comes to planning for any long-term care needs.

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[8] See §§ 7702B(b) and (e); Priv. Ltr. Ruls. 2009-19-011 (February 9, 2009) and 2011-05-001(February 4, 2009). The LTC portion cannot offer cash value itself (other than upon death or surrender) and there must be adequate risk shifting and risk distribution. The issue of just how much risk shifting and risk distribution must be present in order for the LTC component to be honored as LTC insurance was touched upon (but not really answered) in Private Letter Rulings 2009-19-011 and 2011-05-001 – and Notice 2011-68 seeks comments on this topic – but it generally means that some meaningful portion of the LTC benefit has to come from pure insurance rather than the cash value.

[9] We say this while acknowledging § 101(g), which allows a life insurance contract to pay the LTC expenses of an insured who is "chronically ill," and for those payments to be income-tax-free as a form of accelerated death benefit (it is not available with annuity contracts). Those who claim that cash values can be used tax-free to pay LTC expenses are generally not referring to this section, which has been in effect for over ten years and has nothing to do with the 2006 Pension Protection Act or the year 2010. What's more, in order to use § 101(g), the life insurance contract itself has to contain a special provision offering this feature, and not all do – it would generally demand a larger premium – so it's still not the case that the cash value of a run-of-the-mill life policy or annuity can be tapped tax-free to pay LTC expenses. Northwestern Mutual life contracts are among those that don't offer this feature, although we do offer a "terminally ill" accelerated death benefit.

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