Genworth Financial

Exchanging Annuities and Life Insurance for Long Term Care Insurance

1035 Exchange FAQs

Make sure that your customer has independent tax and legal advice on all section 1035 exchange issues.

1. **What is a 1035 exchange?** IRC section 1035 permits owners of life insurance and non-qualified annuities to exchange all or a portion of their policies or contracts for certain related types of contracts without being taxed on any unrealized gain at the time of transfer. A life insurance policy can be exchanged for another life insurance policy (for 1035 exchange purposes, TLC is considered a life insurance policy) or an annuity contract. A deferred annuity can be exchanged for a deferred or immediate annuity contract. Both life insurance and annuities may be exchanged tax-free for stand-alone (traditional) tax qualified long term care insurance.

   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. A representative should carefully consider whether a replacement is in the best interest of the client before making a recommendation to replace the existing product.

2. **How can an annuity be exchanged for long term care insurance?** One type of 1035 exchange is an exchange from a new or existing non-qualified annuity to pay for a tax qualified long term care insurance policy. Any gains transferred as part of the 1035 exchange to pay long term care insurance premiums would be tax free.

3. **What is a non-qualified annuity?** Non-qualified annuities are those that are funded with after-tax money (and from a source other than a qualified plan or account) or a 1035 exchange (for example, from another non-qualified annuity contract) and provide tax-deferred growth.

4. **What is a tax qualified long term care insurance (LTCI) policy?** A tax qualified long term care insurance policy is one that complies with section 7702B of the Internal Revenue Code of 1986, as amended. Benefits received from such a policy for qualified long term care expenses may be federal income tax free.

Life insurance is underwritten and annuities are issued by Genworth Life and Annuity Insurance Company, Richmond, VA; Genworth Life Insurance Company, Richmond, VA; and Genworth Life Insurance Company of New York, New York, NY. Long term care insurance is underwritten by Genworth Life Insurance Company and in New York, by Genworth Life Insurance Company of New York.

Only Genworth Life of New York is admitted in and conducts business in New York.

5. **Must my client exchange the entire deferred annuity to get this benefit?** No, partial exchanges are permitted. The IRS has issued guidance (Notice 2011-68) confirming that partial exchanges to LTCI are permitted and that gain and basis are transferred in a pro-rata fashion.

6. **What types of annuities can be used for this exchange?** Any non-qualified annuity may be used, subject to limitations set by the transferring company.

7. **Are there restrictions for the Genworth Financial insurance companies' (Genworth) insurance products?** Immediate or deferred fixed annuities may be eligible for full or partial 1035 exchanges. *However, immediate annuity contracts with restriction endorsements or irrevocable payees may not be eligible. Genworth RetireReady℠ One and Personal Income Design One variable annuities are eligible for partial 1035 exchanges.* Other Genworth issued variable annuities are not eligible for partial exchanges – only full. Annuities issued by other companies may be eligible, subject to the issuing company's restrictions. The issuing company should be contacted to verify eligibility.

8. **Do the 1035 rules apply to life insurance as well?** Yes, but most life insurance policies 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. Genworth will permit partial 1035 exchanges from certain of our newer cash value life insurance policies to pay traditional LTCI premiums (subject to suitability approval). One alternative may be to 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, such as Total Living Coverage® (TLC). You may contact the Advanced Sales team to discuss your client's particular situation.

9. **My client has a variable annuity with more cost basis than contract value. Would there still be a tax benefit associated with the 1035 exchange?** There is unlikely to be any tax benefit to exchanging a deferred annuity with no gain for a long term care insurance policy.

10. **Does it matter if the annuity has already been annuitized?** If the client is receiving income from an existing annuity, they may designate all or part of the income from that annuity to pay their LTCI premiums by submitting the appropriate 1035 exchange authorization form. However, keep in mind that once annuitized, the payment date and mode typically cannot be changed. Annuities issued by other companies may be eligible, subject to the issuing company's restrictions. The issuing company should be contacted to verify eligibility.

11. **What is the benefit from exchanging an annuity for long term care insurance?** By exchanging an annuity to pay for long term care insurance premiums, the owner may avoid taxes on the gain portion of the amounts exchanged, which would otherwise be taxable when withdrawn from the annuity.

12. **What is the value of this tax treatment?** Under federal tax law, partial withdrawals from a deferred annuity are generally taxed as ordinary income to the extent of gain in the contract. Payments from a fixed immediate annuity receive an exclusion ratio – meaning that a portion of the premium will be tax-free until all basis has been recovered from the contract. The benefit of a tax free transfer of funds from an annuity vary based on the tax situation of the owner and the percentage of gain in the annuity. For example[1], if half the contract value of a deferred annuity is gain, then half the amount 1035 exchanged to pay a LTCI premium would also be considered gain. Because it is a tax-free exchange, though, that gain is not taxed. If a $2,000 long term care insurance premium is paid from such an annuity, then taxes on $1,000 would be avoided. If the owner is taxed at a 35% marginal rate, then this would avoid up to $350 in taxes. This tax savings needs to be compared against any available federal tax deduction and state tax deduction or credit that the policyholder might be entitled to by paying long term care insurance premiums with after-tax money. In particular, for those who itemize, eligible long term care insurance premiums (the lesser of actual premiums or age-based limit amounts) may be deductible as unreimbursed medical expenses.

13. **How does this tax treatment affect long term care insurance premiums?** The tax savings in the example above could effectively reduce the cost of the long term care insurance by $350, or about 17.5%. If the policyholder had not used this withdrawal to pay for the long term care insurance, they would have had to pay $350 in taxes on the $2,000 withdrawal, even if they had used other funds to pay their long term care insurance premiums. Keep in mind when LTCI premiums are paid out-of-pocket there is the potential for a federal deduction of some or all the premiums, as well as state deductions/credits. These tax deductions may not apply if paying via a 1035 exchange.

14. **If my client has recently received an annuity withdrawal, can they make a 1035 exchange by submitting a check (or endorsing the un-deposited withdrawal check) to pay the long term care insurance premium?** No, the exchange must be made in a "hands off" fashion. That is, the transfer of funds can't pass through the annuity owner's hands or financial accounts. It must occur between or within insurance companies. If proceeds from the annuity are received by the owner, they may be liable for taxes even if the owner later uses that money to pay for long term care insurance premiums.

15. **Can more than one annuity be used?** Yes, funds from one or more annuities can be transferred by 1035 exchanges to pay LTCI premiums.

16. **How do payments for an existing Genworth LTCI policy work?** In order for policyholders to make LTCI premium payments from their Genworth annuities, they must complete the applicable 1035 to LTCI exchange form (see list of forms in #28 below) and submit it to the address provided on the form. For SPIA funding LTCI, we request the payment mode to be annual and the payment date needs to coincide with the premium due date.

[1] This is a hypothetical example used for illustrative purposes only.

17. **Can the sole owner of an existing life insurance policy or annuity pay for a jointly owned LTCI policy via 1035 exchange?** No, nor can a jointly owned life policy or annuity be 1035 exchanged to pay a single owner LTCI policy. The owner(s) of the life policy or annuity must be the same as the policyholder(s) of the LTCI policy. For example, a single-owner annuity LTCI policy with the same single owner; or a jointly owned annuity to an LTCI policy with the same joint owners. Depending on how the policy is structured, a shared-benefit LTCI policy could be considered individual owner/joint insureds; joint owners/joint insureds; or separate individual owners/ separate individual insureds. For example: Privileged Choice® Shared Plan is considered one policy with joint owners and insureds, while Privileged Choice® Flex with the Shared Coverage Rider would be separate individual policies linked by a shared rider.

    If the ownership of a life insurance policy or annuity does not match that of the LTCI policy to which the exchange is desired, an option may be to change ownership of the existing policy or contract to create the desired match (if permitted by such policy or contract). While changing ownership of an annuity contract is generally treated as a taxable event, ownership changes between spouses are tax-free.

18. **Must insured(s) match insured(s) on life to LTCI exchanges?** Yes. For exchanges from a life insurance policy to LTCI, Genworth requires that the owner(s) and insured(s) on the transferring policy exactly match the owner(s) and insured(s) on the LTCI policy.

19. **Must annuitant(s) match insured(s) on annuity to LTCI exchanges?** As a general rule, we don't require a match of annuitant(s) to insured(s) for exchanges from annuities to LTCI (just that ownership match). An exception is that we do require such a match if a life contingent Genworth SPIA is used to pay a Genworth LTCI policy (this is a business rule, not a 1035 exchange requirement). It's important to remember that both the transferring and receiving insurance companies must agree that 1035 exchange requirements have been met. Some companies may require that annuitant(s) exactly match insured(s) on the LTCI policy. If a 3rd party insurance company is involved, it would be wise to check with them as to their 1035 exchange requirements.

20. **Can a life insurance policy or annuity owned by a business entity or trust be 1035 exchanged for a LTCI policy?** Only if the LTCI policy has the same owner and the LTCI policy language permits non-natural ownership. Genworth LTCI policies don't permit ownership by a business entity or trust, so any 1035 exchanges would have to come from individually owned policies or contracts.

21. **How will partial 1035 exchanges from a Genworth deferred annuity to a Genworth LTCI policy be processed?** Payments for a Genworth Life Insurance Company or Genworth Life Insurance Company of New York long term care insurance policy will be handled on an annual basis and will be processed automatically each year until canceled by the policyholder. If there are insufficient funds in the annuity to make the payment in full, the policyholder will be notified and given the opportunity to switch to direct billing from that point forward. If the annuity owner is purchasing a new long term care insurance policy, the first three months' premium must be paid from sources other than a 1035 exchange.* Once the policy is issued, 1035 exchanges can be used to pay ongoing premiums. If both the annuity and long term care insurance policy are administered by Genworth Life (or Genworth Life of New York in New York), we will automatically make the withdrawals and payments each year according to the owner's wishes. The deferred annuity contract owner/policyholder may terminate this arrangement at any time by simply notifying our customer care center at 888 GENWORTH. For immediate annuity contract holders see question 26 regarding termination of assignments.

22. **How does it work if the annuity is issued by another company?** We will notify the policyholder annually when premiums are due. If the transfer is from a deferred annuity then we will provide them with the 1035 exchange request forms that they should sign and forward to their annuity company. That company may also have paperwork for the annuity owner to complete. If the transfer is from an immediate annuity then the assignment request must come from the annuity contract owner to the annuity issuer, and using the annuity issuer's 1035 exchange/assignment form. The company that issued the annuity should then transfer the funds directly to us to pay the LTCI premium.

23. **Will surrender charges be incurred during a 1035 exchange?** Deferred annuities may assess surrender charges on withdrawals in excess of certain amounts and taken prior to the end of a prescribed holding period. *If the annuity is within its surrender charge period and the amount transferred to fund a LTCI premium is greater than what is permitted under the contract's free withdrawal limit, or the annuity contract does not have a free withdrawal limit, the excess amount will be subject to a surrender charge.*

24. **How large an annuity is needed to fund a typical LTCI policy?** There are many factors that will affect this decision, but there is no limit on the size of an annuity that may be used for partial exchanges and still receive 1035 exchange treatment.

25. **Do New York's Reg 60 rules apply?** The current version of New York's Reg 60 does not apply to exchanges from an annuity contract or life insurance policy to a long term care insurance policy. That situation may change in the future.

*In states of NH (ages 65 and older) and CA, one month's premium must be submitted.

26. **Do payments from a Genworth non-qualified SPIA assigned to pay a long term care insurance policy qualify for 1035 tax treatment?** Yes, however there are some specific requirements that must be met:

- The payee for SPIA payments funding the LTCI policy must be the long term care insurance issuing company.
- The owner(s) of the SPIA contract must be the same as the policyholder(s) of the LTCI policy. In addition, to facilitate termination of assignments when LTCI policy premiums are no longer required, if a Genworth life contingent SPIA is used, we will also require that the annuitant(s) match the insured(s).
- We require the payment mode to be annual and the payment date should align with the due date for the LTCI premium. Once issued, the payment mode, date and amount of a SPIA cannot be changed.

  In order to ensure SPIA payments match LTCI premiums upon issue, close attention must be paid to both companies' rate hold periods.

  It is important to understand that if the LTCI premium increases, the SPIA payment may no longer be sufficient to cover the cost of the LTCI policy.
- When using a Genworth SPIA, form 49787 (new SPIA contracts) or Form 49787PI (existing SPIA contracts) must be completed by the SPIA contract owner(s).
- We require an irrevocable assignment of the portion of the SPIA contract that is funding a LTCI policy. The SPIA contract owner(s) accomplish the irrevocable assignment by signing and submitting Form 49787 or 49787PI.

  The assignment does not affect the ability to split SPIA payments (see question 26), however while the assignment is in-force, the ability to advance or commute any SPIA payments is subject to the assignment. In addition, the owner(s) of the SPIA contract cannot change the LTCI payee while the LTCI policy premiums are required.

  The assignment ends when LTCI premium payments are no longer required, for example, when a limited pay policy is fully paid up, when the insured goes on claim or with the termination of the LTCI policy (upon the insured's death or otherwise).
- To ensure accurate tax reporting of SPIA payments, the Genworth companies' SPIA contract owner(s) should immediately notify Annuity Services at any time LTCI premium payments are no longer required and a change of payee is needed.

27. **Can SPIA payments be split where part of the payment is used to fund a long term care insurance policy and part of the payment is sent to the owner's checking account?** Yes, but again, the insurance company issuing the long term care insurance policy must be listed as the payee for the portion of the immediate annuity payment that is funding the long term care insurance policy. Unless the IRS issues instructions requiring different reporting: If the SPIA is issued by GLAIC, the portion of the payment directly funding long term care insurance will be reported by us on Form 1099-R as taxable amount: $0.00 (zero); if the SPIA is issued by GLIC, then no tax reporting is required as to the payment amount assigned to the LTCI policy. Normal tax rules will apply to any portion of an immediate annuity payment that is not directly funding a long term care insurance policy and a separate Form 1099-R will be issued.

28. **How will commissions be paid for new LTCI applications?** Commissions are normally paid once a full modal premium is received in the home office. Since the 1035 exchange only permits annual mode, commissions are not paid until a full year's premium is received. If an application for a new LTCI policy is submitted with a full year's premium, commissions will be paid as usual at policy issue. If the three month minimum is submitted, commissions will not be paid until the policy is delivered and accepted and the remainder of the first year's premium is received via the annuity withdrawal. This could be several months after the policy application is submitted.

29. **What happens to the 1035 exchange payments when the policyholder goes on claim?** If the policyholder goes on claim and has waiver of premium, then the billing system will suspend billing. Any excess premiums are routinely refunded to the policyholder. (Note that not all policies have waiver of premium.)

    - If it is another carrier's deferred annuity, no Letter of Instruction (LOI) would be sent to the other carrier, so no exchange would occur.
    - If it is a Genworth deferred annuity, there would be no invoice to the annuity system/team, so no exchange would occur.
    - If it is a SPIA (or any annuitized contract for that matter) that is assigned, then the annuity (carrier) automatically sends checks to us each year. Those payments would be refunded to the policyholder.
    - To ensure accurate tax reporting of SPIA payments, Genworth SPIA contract owner(s) should immediately notify Annuity Services at any time LTCI premium payments are no longer required and a change of payee is needed.
    - Any "unearned" premium at time of claim that equals one full modal premium or more would generate a refund to the policyholder as well.
    - Amounts refunded under the waiver of premium benefit will be reported as per diem amounts on Form 1099-LTC.

30. What forms are required to initiate a 1035 exchange from an annuity contract or life insurance policy to an LTCI policy? Contact your Genworth Representative for additional information or updates.

Typical Steps to Complete Common Exchange Opportunities		
Annuity Type	**Existing LTCI Policy**	**New LTCI Policy**
Existing Deferred Annuity	Submit form 42923LTC.	• Receive new LTCI policy and annual premium amount. • Submit form 42923LTC with LTCI application referencing the existing annuity contract.
New Deferred Annuity	• Fill out application and all required forms to fund the new annuity contract. • Submit form 42923LTC.	• Receive new LTCI policy and annual premium amount. • Fill out application and all required forms to fund the new annuity contract. • Receive new annuity contract. • Submit form 42923LTC.
Existing Genworth Immediate Annuity	• Submit form 49787PI to certify payee is LTCI issuer and specify policy#, irrevocably assign applicable portion of SPIA, and change Payee/income allocation as needed. • The SPIA payment date and mode cannot be changed. It may be necessary to change LTCI premium due date to align with the SPIA payments.	• Receive new LTCI Policy and annual premium amount. • Align LTCI premium due date with SPIA payments. • Submit form 49787PI to certify payee is LTCI issuer and specify policy#, irrevocably assign applicable portion of SPIA, and change Payee/income allocation as needed.
New Genworth Immediate Annuity	• Fill out application and all required forms to fund the new annuity contract and make payee the LTCI. • Submit form 49787 to certify payee is LTCI issuer, specify policy# and irrevocably assign applicable portion of SPIA • Submit with SPIA application.	• Receive new LTCI policy and annual premium amount ,first premium is paid out of pocket. • Fill out application and all required forms to fund the new annuity contract and make payee the LTC Insurance Company. • Align first annual payment date to the LTCI annual premium due date. • Submit form 49787 to certify payee is an LTCI issuer, specify policy# and irrevocably assign applicable portion of SPIA. • Submit with SPIA application.

31. **Additional considerations:**

In the event a rate increase occurs on the long term care insurance policy, subject to the terms of the policy, the policyholder may be given the choice to:

- Increase their deferred annuity exchange amount or purchase another SPIA to create the additional income required to pay the higher premium.
- Reduce their LTCI coverage to bring their new premium down to offset the rate increase.
- Elect to be direct billed for the balance not paid by an annuity.
- Terminate the LTCI policy or possibly obtain a reduced paid up policy and receive the annuity payments directly.

Important Information: The Genworth Financial companies developed these FAQs to help you understand the ideas discussed. Any examples are hypothetical. They may not reflect your client's particular circumstances. Your clients should carefully read their contract, policy and prospectus(es), when applicable. What we say about legal or tax matters is our understanding of current law. We are not offering legal or tax advice. The tax information in this material was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in this material. Tax laws and IRS administrative positions may change. We did not develop these FAQs for use in avoiding any IRS penalty and neither you nor your clients may use it for that purpose. Your clients should ask their independent tax and legal advisors for advice based on their particular circumstances. We reserve the right to change the information reporting described herein to comply with forms and instructions issued by the Internal Revenue Service.