

Understanding the Provisions of the Pension Protection Act: Partial 1035 Exchanges and Tax Treatment of Long Term Care Insurance

Currently, there is a great deal of discussion and carrier positioning around provisions in the Pension Protection Act of 2006 (PPA), specifically about the tax treatment of allowing a partial 1035 exchange to fund new or existing long term care insurance premiums and the tax position of annuity/long term care insurance (LTCL) linked benefit products.

To help you sort through the information, we want to share with you background on the issues and Genworth's stance. First, a few highlights about Genworth:

- Since 2006, when the PPA was first enacted and in preparation for the January 1, 2010 effective date, we have extensively analyzed the provisions of the act and the opportunities for using annuities to fund long term care insurance.
- Members of our legal team were among the experts who helped draft the substantive conclusions and requests for published guidance concerning partial 1035 exchanges to fund qualified long term care insurance contained in a letter dated November 23, 2009, from the ACLI to the Treasury Department and Internal Revenue Service (ACLI letter).
- We have consulted with leading experts to validate our position, and we aligned our processes with the legal interpretations stated in the ACLI letter.
- As an insurance industry leader, we are prepared on multiple fronts to help you and your clients benefit from the opportunities presented by the PPA. We designed our operating platforms and products to offer appropriate options to consumers, and we are delivering industry-leading education to train our distributors and producers on how they can serve their clients.
- Genworth believes that when Congress enacts laws providing tax benefits for insurance products, insurance companies should establish administrative processes to allow customers to benefit from those laws.

Interpreting the Provisions

Section 1035(a) of the Internal Revenue Code (Code), as amended by the PPA, is currently in effect and is not an elective provision. Delaying implementation of 1035 exchanges to fund long term care insurance would only make sense if section 844(b) of the PPA were *proposed* legislation.

In addition, the only sure way to *avoid* a 1035 exchange of "an annuity contract for a qualified long term care insurance contract" under Code section 1035(a)(3) is for the insurance company issuing a long term care insurance contract to refuse to receive funds from an internal or external issuer of an annuity contract. However, such a refusal is contrary to Congressional intent in enacting the PPA.

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The ACLI letter notes that, before the PPA, annuity distributions were used to fund LTCI and describes the “overriding purpose of the legislation” as follows:

“Congress believed that consumers would benefit if there were additional ways to acquire long-term care insurance. The legislation permits the combination of annuity and long-term care contracts to encourage more individuals to take the financial responsibility for their care when they become too old or infirm to care for themselves.”

The ACLI letter also states that partial 1035 exchanges of annuities to fund qualified LTCI are consistent with the intent of the law, and asks the Internal Revenue Service (IRS) to publish follow-up guidance on this issue:

“... in order for owners of annuity contracts to accomplish a tax-free exchange of the annuity contract for LTC insurance, it is necessary for the owner to engage in a series of partial IRC §1035 exchanges. We request that the Service issue guidance that explains that such exchanges are permitted under the PPA of 2006 in tax years after 2009.”

It is also important to note that there is nothing in the Code or regulations prohibiting partial 1035 exchanges to fund qualified LTCI. Additionally, a Tax Court ruling (the Conway case)* held that the IRS lacks the authority to prevent partial exchanges [to another annuity contract] because there is no such limitation in the Code or related regulations.

Our Position

Genworth believes that the PPA provisions may be implemented now by carriers who have the essential capabilities in place. While other carriers may choose to delay implementation of these provisions until the IRS issues further guidance – in effect disallowing annuity funding of LTCI out of uncertainty of adverse tax treatment – the Genworth companies are honoring the spirit and content of the PPA as described in the ACLI letter, which states:

“We believe that the Conway case and [IRS rulings] strongly support the position that the owner of an annuity contract may apply a portion of the cash value of the contract toward the payment of a premium on a qualified LTC insurance contract.”*

We continue to accept annuity fund transfers into our tax-qualified traditional LTCI policies and linked-benefit annuity/LTCI product. For any qualified LTCI issuer, the most important order of business is to provide solutions for consumers to help protect their finances and their families; therefore, it makes sense to accept premium from *any* legitimate source that helps to meet this need.

Tax reporting, like section 1035 itself, is not optional for internal exchanges and external exchanges to other company’s LTCI products. We have clearly stated that we plan to treat these exchanges as generally non-taxable for reporting purposes unless this approach is contrary to future instructions issued by the IRS. And although it is our good faith belief that such exchanges should be reported as non-taxable, we advise customers to consult with their own tax advisors before engaging in an exchange.

Producers and clients can be confident that we employ the highest level of integrity and sound risk management strategies in crafting our products and service offerings and in complying with both the letter and intent of regulations.

**Conway v. Commissioner*, 111 T.C. 350 (1998), acq., 1999-2 C.B. xvi.

What we say about legal or tax matters is our understanding of current law. We are not offering legal or tax advice. Tax laws and IRS administrative positions may change. We did not develop these materials for use in avoiding any IRS penalty and neither you nor your clients may use it for that purpose. Insurance companies' tax reporting practices may vary. Your clients should ask their independent tax and legal advisors for advice based on their particular circumstances.