Annuity-Based LTC: Making the Case

In the Asset-Based Long-Term Care (ABLTC) segment, a detail that must be considered and is often overlooked is the source of funds. Specifically, clients need to understand the pros and cons of using non-qualified funds versus qualified funds and annuities versus brokerage accounts when funding their care planning strategy.

This becomes even more important when we consider the tax ramifications specific to each funding source, particularly when considering non-qualified annuities. There's an opportunity to avoid a taxable event altogether by selling an annuity-based ABLTC product. The availability of a tax-free 1035 exchange into an annuity-based ABLTC product unlocks the power of the Pension Protection Act and changes the true cost of the care planning strategy.

Tax Impacts on LTC Planning

These cases often follow a "Money Purchase" approach that starts with the existing annuity's cash value as a single premium to purchase an ABLTC solution. Taxes on annuity liquidation can significantly impact decision-making, as the net amount is then used as the single premium on a life-based solution, while the full amount can be used to fund an annuity-based product. Please see Table 1 for an example.

Table 1: Impact of Taxes on Non-Qualified Annuities

Product Type	Life-Based ABLTC Taxes Considered	Annuity-Based ABLTC Taxes Considered
Annuity CSV	$200,000	$200,000
Cost Basis	$100,000	$100,000
Income Tax Rate	34%	0%
Taxes Due[1]	$34,000	$0
Net Premium	$166,000	$200,000

[1]Tax Rate Assumptions: 24% Federal, 10% State, for a combined 34%

An increased premium in annuity-based products typically leads to richer LTC benefits, but this doesn't guarantee superiority over other life-based products. The fundamental question is if the increased funding into the annuity-based solution offsets the superior leverage typically found in life-based products. In this case, with a 35% combined tax rate assumption, the life-based product must deliver a 20.48% greater monthly benefit per dollar of premium to match the benefits of an annuity-based solution.

The Impact of After-Tax Cash

Revisiting the cash flows from Table 1, now including the corresponding monthly benefit amounts, shows not only the superior outcome of the annuity-based solution for this case, but also how it could have been "hidden" if the reduced, after-tax deposit amount was not used. Please see Table 2 on the following page for additional details.

Table 2: Impact of Taxes on LTC Benefits

Product Type	Life-Based ABLTC Taxes Not Considered	Life-Based ABLTC Taxes Considered	Annuity-Based ABLTC Taxes Considered
Annuity CSV	$200,000	$200,000	$200,000
Cost Basis	$100,000	$100,000	$100,000
Income Tax Rate	0%	34%	0%
Taxes Due[1]	$0	$34,000	$0
Net Premium	$200,000	$166,000	$200,000
Monthly Benefit at 80	$11,150	$9,254	$10,286
ROP/CSV at 80	$149,743	$124,287	$155,481
Death Benefit at 80	$199,113	$165,264	$155,481

[1]Tax Rate Assumptions: 24% Federal, 10% State, for a combined 34%

Other Considerations

While the primary metric in a care planning case is usually the monthly benefit amount, other factors like the death benefit and liquidity should also be considered. Death benefits from life-based products are typically larger and tax-free for beneficiaries, while annuity-based products often provide greater liquidity. These factors are a key part of the decision-making process.

Another important point to consider is the use of a COLA Rider. Annuity-based products may perform better without a COLA Rider due to current crediting rates, but these benefits are not guaranteed. In contrast, the benefits available from the COLA Rider are contractually guaranteed and may be more suitable for clients seeking reliability.

A potential complication is the annuity with a surrender value in excess of the premium needed to fund the strategy. Carriers offering annuity-based ABLTC products can often execute a “split 1035 exchange,” allocating funds between an ABLTC product with another annuity. While this adds complexity, it can create additional flexibility for clients. Additionally, annuity-based products may offer simplified underwriting, which may benefit clients with certain health conditions.

Next Steps

Fortunately, taking the impact of taxes into account in these scenarios involves only two additional pieces of data and a bit of math: When working with non-qualified annuities, always calculate the net premium amount using the cost basis and an income tax rate assumption when not utilizing a 1035 Exchange. Use the resulting net proceeds available to fund a life-based product and run proposals for both life-based and annuity-based products accordingly. The results may surprise you!

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