Thursday, October 2 2014 **WRM# 14-39**

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: 1035 Exchanges of Life Insurance Policies – How Easy Are They Really.

MARKET TREND: Complex tax laws and the emergence of new, more sophisticated life insurance products emphasize the need for life insurance solutions that offer flexibility to adapt to changing circumstances.

SYNOPSIS: Internal Revenue Code ("Code") § 1035(a) allows the exchange of a life insurance contract for another, generally without requiring recognition of gain upon the exchange. Failure to understand the technical components of 1035 exchanges, however, can lead to unanticipated tax consequences, including the receipt of taxable "boot," the unintentional acquisition of a "MEC," and the potential loss of grandfathered status for split-dollar arrangements. Yet, with proper implementation, 1035 exchanges also can provide significant insurance planning flexibility, allowing clients to exchange policies to (1) access more cost-effective or higher return products, (2) make changes to coverage levels based on current needs, (3) reduce or modify scheduled premium outlays, or (4) diversify coverage exposure among insurance carriers.

TAKE-AWAYS: Preserving the intended tax-deferral features of 1035 exchanges requires strict compliance with certain technical requirements and careful analysis of the policies that will be exchanged. In addition, clients need comprehensive solutions for their life insurance plans that will address both overall tax implications and their family's changing circumstances. Thus, advisors can add value to their clients by periodically reviewing the sufficiency of a client's coverage, identifying opportunities for exchanges to acquire better or more cost-effective insurance products, and understanding the technical nuances of exchange implementation in order to effect a compliant 1035 exchange.

MAJOR REFERENCES: *Code § 1035*; *Treas. Reg. § 1.1035-1*.

WHAT ARE 1035 EXCHANGES

Code § 1035(a) is a "like-kind" property exchange provision, which allows the exchange of a life insurance contract for another life insurance contract, generally without requiring recognition of gain or loss upon the exchange (a "**1035 exchange**").[1] The new policy received in the exchange takes a carry-over tax basis equal to the old policy's basis.

WHY USE 1035 EXCHANGES

1035 exchanges are fundamentally about flexibility. The Code section was intended to defer taxation for individuals who "merely ***exchanged one insurance policy for another better suited to their needs and who have not actually realized gain***."[2] In this context, clients may seek or benefit from a 1035 exchange for numerous reasons, including:

- **Availability of New Products**. Clients can exchange polices to obtain new, more sophisticated products that may provide higher returns, better mortality projections, more cost-effective coverage, or guarantees.
  - *Example:* Due to positive changes in a client's health and adjustments to an insurer's mortality tables, a client may exchange his policy for similar coverage at lower premiums.
- **Economic Changes**. A change in the overall economic environment may shift interest to different products. For example, when facing a rising interest rate environment, a client may want to change coverage to an interest-rate sensitive universal life product.
- **Need/Desire for Changes in Coverage**. The sale of a company or other adjustments in business ownership or position and changes in family obligations, estate liquidity, etc. may recommend exchanging an existing policy for different coverage.
  - *Example:* Client sells his business and significantly boosts his liquid assets. With decreased estate liquidity concerns, he may want to exchange his high death benefit policy with on-going premiums for a fully paid-up policy with a lower death benefit. Alternatively, the client may no longer need access to the policy's cash value for retirement income. He may want to exchange the policy for a guaranteed death benefit policy that ensures a maximum pay-out to his heirs.
- **Need to Reduce or Modify Premium Outlays**. Changes in clients' financial circumstances also may impact their ability to make premium payments at a certain level and/or on a fixed schedule, necessitating an exchange for a policy with lower premiums or greater flexibility in payment structure.
  - *Example:* Client is anticipating a significant business investment that will limit his cash flow and liquidity for several years. She exchanges her current policy for a universal life policy with similar coverage but allowing greater flexibility in timing and amount of premium payments.
- **Adverse Changes in Current Insurer's Financial Condition.** A client concerned with the current insurer's ability to pay policy dividends or future death benefits can transfer coverage obligations to a new insurance carrier who has demonstrated greater financial stability.

WHAT ARE THE REQUIREMENTS

Same Owner/Same Insured. To qualify as a 1035 exchange, the exchanged policies must (1) have the same owner and (2) relate to the same insured. Thus, a policy owner cannot 1035 exchange a policy for a new policy with a new insured (*e.g.*, as may be allowed under "policy exchange riders," which permit a business to switch the insured under a key-employee policy to replace terminated or departed employees.) A policy owner, however, can use a 1035 exchange to consolidate two life insurance policies on the same insured into one.

No Single Life to Survivorship Exchanges. A single life policy insuring one individual cannot be 1035 exchanged for a survivorship policy insuring the same individual and another person (such as a spouse). The IRS also has privately ruled that two individuals separately insured on single life policies will ***not*** constitute the same "insureds" if jointly insured on a survivorship policy for purposes of a 1035 exchange.[3] Applying this ruling, the exchange of two single life policies insuring respective spouses for a survivorship policy insuring both spouses would ***not*** qualify as a 1035 exchange.

Survivorship to Single-Life Exchanges Possible. Interestingly, the IRS has privately ruled that, ***after the death of one insured***, the exchange of a survivorship policy for a single life policy insuring the surviving insured ***qualifies as a 1035 exchange***.[4]

Changes in Product Type Allowed. As long as the above requirements are met, exchanges of policies involving permanent coverage to obtain a different type of product (*e.g.*, universal to variable, whole life to limited-pay, etc.) should not impact qualification as a 1035 exchange.[5]

WHEN 1035 EXCHANGES WON'T HELP

Eliminating MEC Status. "Modified endowment contracts" ("**MECs**") are life insurance contracts where the total premiums paid in the first seven years of the policy exceed the amount needed to provide for a paid-up policy based on statutorily set level annual premiums (*i.e.*, the "seven-pay test").[6] Unlike non-MECs, MEC withdrawals, surrenders and loans (including pledges of the MEC as loan collateral) are taxed as ordinary income until they exceed any gain in the MEC, and an additional 10% penalty tax may apply to the amount included in gross income, with limited exceptions.[7]

A policy received in a 1035 exchange for a MEC will also be considered a MEC. Thus, a ***1035 exchange cannot eliminate MEC status***, regardless of how many exchanges occur.[8]

Failure to Obtain Notice & Consent for EOLI Policies. Code §101(j) taxes a business' receipt of otherwise tax-free death benefits if they are paid under an "employer-owned life insurance" ("**EOLI**") contract.[9] Broad exceptions to taxation apply, but only if the business satisfies certain notice and consent requirements with regard to the insured employee before issuance of the EOLI contract.[10] If a business owns an EOLI policy and did not satisfy the employee notice and consent requirements before issuance of that original policy, a 1035 exchange will not correct the error, ***unless the business satisfies the notice and consent requirements before issuance of the new policy in the exchange***.[11]

WHAT ISSUES TO AVOID

While 1035 exchanges can provide significant flexibility in life insurance planning, oversights in execution may have unintended and adverse tax consequences. Knowledgeable insurance advisors can add significant value to their clients by streamlining the exchange process and helping clients avoid these trouble spots.

Testing for MEC Status. The new policy received in a 1035 exchange for a non-MEC policy must undergo a seven-pay test to determine whether it constitutes and will be taxed as a MEC.[12] The ***risk of failing this test for the new policy may increase if there is a reduction in its death benefit compared to the old contract or if the owner contributes additional funds at the time of the exchange***.

- ✓ Advisors also should pay particular attention to potential 1035 exchanges of policies issued before June 21, 1988, as they are grandfathered from MEC testing. A 1035 exchange of these older policies is a "material change" for MEC testing purposes and will cause the loss of the grandfathered tax protections if the new policy fails the test.

New Period for "Force-Outs". A withdrawal of policy cash value in the first 15 years of a non-MEC contract that reduces the future death benefits may generate an immediate income tax liability. The withdrawal is includable in gross income to the extent of the policyholder's gain in the contract (excess of the policy's cash value over the policyholder's basis), up to a "recapture ceiling," and may be referred to as "forced-out gain." A policy received in a 1035 exchange is treated as a ***new*** policy for purposes of Code §7702 (definition of life insurance), including with regard to the 15-year period for force-outs.[13]

Taxable Boot. Any money or other non-like kind property ("**boot**") received in a 1035 exchange in addition to the new policy does not qualify for non-recognition treatment and may result in reportable gain to the taxpayer.[14] Situations that may generate taxable "boot" include the following:

- *Outstanding Policy Loans*. A 1035 exchange of a policy subject to an outstanding loan generates boot if the loan is not carried over to the new policy and policy cash values are used to satisfy the loan (as discussed below, using policy withdrawals to pay-off a policy loan prior to or shortly after the exchange also may result in taxable boot). The client will recognize gain equal to the lesser of the boot or the difference between the policy's cash value and the client's basis in the old policy.

    - *Example:* B owns Policy 1, with $100,000 of cash value, a $70,000 tax basis, and an outstanding policy loan of $40,000. B exchanges Policy 1 for Policy 2, which is issued without any loans. For tax purposes, B's amount realized is $100,000 - $40,000 of boot (extinguished loan) and Policy 2, with a cash value of $60,000. B recognizes $30,000 of gain ($100,000 amount realized - $70,000 basis in old policy), and B's tax basis in the new policy is $60,000 (B's basis in the old policy ($70,000) – boot ($40,000) + recognized gain ($30,000)).

    - ✓ To avoid boot in these cases, a client can try to exchange the original policy for a new one subject to the same loan amount. Alternatively, the client could pay-off the policy loan before the exchange by using other assets. The client could then borrow from the new policy, as needed, to replace the assets used or to pay-off any other financing obtained.

- *Policy Withdrawals*. The boot treatment of withdrawals made from a policy either shortly before or after a 1035 exchange is problematic. Typically, under Code § 72(e), a taxpayer may treat withdrawals as tax-free returns of basis, up to a taxpayer's basis in the policy (if a non-MEC). The IRS, however, has indicated that withdrawals made from a policy to pay-off an existing policy loan, followed shortly by a 1035 exchange of the policy constitute a single integrated transaction taxable under Code § 1035,[15] resulting in tax on the withdrawal as boot. Interestingly, the IRS reached a different result in a private letter ruling involving the proposed pay-off of a policy loan ***after*** a 1035 exchange by using funds withdrawn from the new policy, holding that the subsequent policy withdrawal would be taxed under Code § 72, not as boot under Code §§ 1035 and 1031.[16]

  Regardless, carriers may, as a matter of course, treat any policy withdrawal made shortly before or after a 1035 exchange (*e.g.,* 6 months) as boot and issue a federal Form 1099 to the

client.[17] While the client may be able to take a position that his particular exchange did not generate boot, both the client and the advisor will likely prefer to resolve or avoid these issues on the front-end, rather than fix them after issuance of the Form 1099.

- ✓ A conservative approach would allow a sufficient time (*e.g.*, 6-12 months) to pass between any 1035 exchange and a policy withdrawal. If a withdrawal is required, it is likely better to make the withdrawal from the new policy after the 1035 exchange, which aligns with the IRS' favorable private ruling. Before implementing the exchange or making any such withdrawal, however, the advisor should contact the carrier to determine how they will treat the withdrawal and whether they will still feel compelled to issue a Form 1099.

Material Modifications of "Grandfathered" Split-Dollar Arrangements ("SDAs"). SDAs entered into on or before and not "materially modified" after September 17, 2003 (the effective date of the final split-dollar regulations) are considered "grandfathered" from the application of the final regulations. The tax consequences of grandfathered SDAs can differ dramatically from those governed by the final regulations. For example, if a business and an insured enter into a SDA governed by the economic benefit regime under the final regulations, the insured is currently taxable on his or her current or future access to policy cash value in excess of the reimbursement due to the business (*i.e.*, the policy equity). Under a grandfathered SDA, however, this policy equity may not be taxable while the arrangement remains in place but may become immediately taxable if the SDA is materially modified.

The final regulations do not address whether a 1035 exchange will be considered a material modification, which means such an exchange could result in a material modification of the grandfathered SDA and taxation under the final regulations.

- ✓ Advisors and clients should not automatically reject 1035 exchanges involving grandfathered SDAs. A change in grandfathered status may not be detrimental in every situation (especially if there is no policy equity), and there are now far more options for life insurance products that may better serve the interest of the parties. Until the IRS provides definitive guidance, however, the potential benefits of the exchange must be carefully analyzed and weighed against the tax consequences of the loss of grandfathered status.

Access to Old Policy's Cash Value. To qualify as a 1035 exchange, the IRS strictly requires an exchange of policies, not an exchange of cash from an old policy for a new policy. The IRS has repeatedly ruled that, when exchanging policies, if the policy owner receives any cash proceeds from the old policy, even temporarily, Code §1035 will ***not*** apply to the exchange.[18]

- ✓ To help ensure tax-deferral treatment under Code § 1035, policy exchanges should be accomplished within the insurance carrier or between the insurance carriers without any issuance of cash proceeds to the policy owner or the insured. The policy owner should sign an absolute assignment of ownership and an exchange agreement with the transferee insurer, transferring all rights in the old policy to the insurer that will issue the new policy.

Issues for Business-Owned Policies. In addition to the above, older, business-owned life insurance policies may benefit from certain grandfathered exclusions that could be jeopardized by a 1035 exchange, including:

- *EOLI*. A new policy received in exchange for a business-owned policy issued on or before Aug. 17, 2006 remains grandfathered from the EOLI provisions (and will not be subject to the employee notice and consent requirements to avoid tax on the death benefits), unless the ***new policy increases the death benefit or makes another material change***. In that case, the business must satisfy the employee notice and consent requirements before issuance of the new policy. When exchanging an existing EOLI policy for which the notice and consent requirements were previously satisfied, the business ***must re-satisfy these requirements prior to issuance of the new policy in the 1035 exchange if there is an increase in the death benefit or other material change in the new policy***.

- *Interest Deductions for COLI*. For businesses carrying policies on employees, officers and directors, Code §264(f) limits deductions for interest expenses on unrelated borrowings with regard to those policies, with exceptions for policies ("**excluded contracts**") that insure, ***at the time of issue***: (i) a 20% owner of the business, or (ii) an officer, director, or employee (collectively, for convenience, "**employees**"). If a business exchanges an excluded contract insuring an individual who is not an employee at the time of the exchange, the new policy will not qualify as an excluded contract, and the business will be subject to a disallowance of a deduction for a portion of its interest expense incurred on unrelated borrowings.

Non-Tax Issues. Advisors and clients also must consider the non-tax ramifications of a potential 1035 exchange, including whether: (1) the client is insurable, (2) the policy owner still has an insurable interest in the insured under applicable state law, (3) the new policy will re-start the policy's contestability period, (4) acquisition costs or cancellation penalties will apply.

TAKE-AWAYS

- Preserving the intended tax-deferral features of 1035 exchanges requires strict compliance with certain technical requirements and careful analysis of the policies that will be exchanged.

- Clients also need comprehensive solutions for their life insurance plans that will address both overall tax implications and their family's changing circumstances.

- Advisors can add value to their clients by periodically reviewing the sufficiency of a client's coverage, identifying opportunities for exchanges to acquire better or more cost-effective insurance products, and understanding the technical nuances of exchange implementation in order to effect a compliant 1035 exchange.

NOTES

[1] This report focuses on the exchange of one life insurance contract for another. Code §1035 (a)(1) also allows a tax-deferred exchange of a life insurance policy for an endowment contract, annuity, or long-term insurance contract.
[2] See H.R.Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).
[3] See PLR 9542037.
[4] *See* PLRs 201304003, 9330040, and 9248013 (all involved trust-owned policies). The IRS states "no opinion on whether section 1035 applies to the exchange of a survivorship or "second to die" life insurance contract for a single life insurance contract prior to the death of either of the insureds under the survivorship contract."
[5] Whether a term policy may be exchanged for a permanent policy has not been addressed by the IRS in published guidance. Some commentators have questioned whether the IRS may claim that an exchange of a term policy for a permanent contract artificially extends the tax-free nature of the contract beyond the original term, thus disallowing §1035 exchange treatment, although they argue it is not justified by the Code or Treasury Regulations (*See, e.g.*, Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, §2.17, Footnote 361 (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through May 2014)(online version accessed on Checkpoint

(www.checkpoint. riag.com) September 2014)). Note also that conversions of convertible term policies to permanent coverage are pursuant to exercises of contractual rights and not "exchanges" under Code §1035.

[6] Applies to contracts entered into or materially modified after June 21, 1988 (Code §7702A).

[7] See Code 72(e)(10) for taxation of gain. See Code §72(v) for application of the additional 10% penalty and exceptions, which include for distributions: (1) made on or after the date on which the taxpayer attains age 59½, (2) which are attributable to the taxpayer's becoming disabled, or (3) which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary.

[8] Clients should also proceed cautiously when trying to consolidate multiple policies insuring a single insured into a single policy, if one or more of the existing policies is a MEC. Note, however, that ***1035 exchanges of MECs may help limit application of the MEC aggregation rule***s. For MEC taxation, all MECs issued in the same year by the same insurance carrier are treated as a single MEC (Code § 72(e)(12)(A). This aggregation prevents a client from buying several small MEC policies and more quickly depleting the gain in each (so that future distributions would be nontaxable returns of basis) as opposed to one large MEC policy. However, MECs received in a 1035 exchange from another carrier ***will not be aggregated*** with the MECs issued by the old carrier.. For example, assume Client owns MECs X, Y, and Z, all issued by Old Carrier in the same year. Client 1035 exchanges Y and Z for MECs issued by New Carrier. If Client later takes a distribution from MEC X, the new MECs will not be aggregated with MEC X for purposes of determining the taxable portion of the distribution.

[9] Generally, where the business owns the policy, and the business (or a related person) will receive the death benefits can constitute EOLI . Applies to only to (1) a policy issued after April 17, 2006, (2) a policy issued on or before April 17, 2006 if there has been a material increase in death benefit or other material change to the policy after that date, and (3) a policy received in a 1035 exchange for an original policy issued on or before April 17, 2006, if the newly received policy has a material increase in death benefit or other material change as compared to the original policy. See *WRMarketplace Report* No. 12-24 for a detailed discussion of EOLI contracts.

[10] Code §101(j)(2). The exceptions are if: (1) the insured under the contract was (a) an employee at any time during the 12 months prior to death, or (b) a director or a highly compensated employee or individual at the time the contract was issued, <u>or</u> (2) the contract death benefits are either (1) paid to the insured's estate, family members, or other designated beneficiaries (other than the policy-holder), or a trust for the benefit of any such individuals, or (2) used to purchase an equity (or capital or profits) interest in the policyholder from any person described above.

[11] *See* Notice 2009-48.

[12] *See* PLR 8816015.

[13] *See* PLR 9044022.

[14] Reported and taxed pursuant to the rules under Code § 1031.

[15] *See* PLRs 9141025 and 8905004; Rev. Proc. 2008-24 (dealing with the exchange of annuity contracts)

[16] *See* PLR 8816015.

[17] *See* Rev. Proc. 20011-38, modifying Rev. Proc. 2008-24 (dealing with the exchange of annuity contracts, where an amount withdrawn from, or received in surrender of, either of the contracts involved in the exchange within 180 days is treated as a taxable distribution).

[18] *See, e.g.*, Rev. Rul. 2007-24 and PLRs 200622020, 9820018, and 8515063. The IRS has taken the position that if cash proceeds are received, the policy owner must have a "binding" obligation to provide the proceeds to the carrier issuing the new policy to qualify for a1035 exchange. However, the IRS has been somewhat more lenient when the exchange involved original policies issued by carriers who have come under financial duress or are subject to a rehabilitation, conservatorship, insolvency, or similar state proceedings at the time of the cash distribution (*see* Rev. Rul. 92-44). *See also Greene v. Commissioner*, 85 T.C. 1024 (1985), where the Tax Court upheld 1035 exchange treatment even though the owner surrendered one annuity contract, received a check, and then endorsed that check to another carrier for issuance of a new annuity contract. Although the IRS acquiesced in the *Greene* decision, its subsequent rulings indicate that its continued position that the policy owner should not have any access to cash proceeds from an exchanged policy.

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