1035 Exchange – A valuable tool

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What is a 1035 Exchange?

A 1035 Exchange allows for the exchange of an annuity or life insurance policy for a new policy without incurring any tax consequences. The Internal Revenue Service (IRS) recognizes that as clients' needs and financial objectives change, they may need to re-evaluate their insurance products. This provision allows holders of certain types of insurance products to exchange to new contracts which may better suit their changing circumstances.

This guide will address the most common situations involving a 1035 Exchange and how to avoid common pitfalls. According to Section 1035 of the Internal Revenue Code (the Code), when properly executed, no gain or loss shall be recognized on the 1035 Exchange of the following products:

	Can be exchanged to this contract			
	Life Insurance	Annuity	Endowment	Qualified Long-Term Care
Life Insurance	Yes	Yes	Yes	Yes
Annuity	No	Yes	No	Yes
Endowment[1]	No	Yes	Yes	Yes
Qualified Long-Term Care	No	No	No	Yes

Important factors to consider

Before executing an exchange, consider the following carefully:

- **New contestability period** – a new contestability period starts with the issuance of a new contract;
- **New free look period** – The new contract would be subject to the applicable state-provided free look period;
- **Underwriting based upon current age and medical status** – While reduced mortality costs may be a prime motivation for the exchange, any changes in health and age may negate perceived cost savings;
- **Modified endowment contracts** – The rule involving a 1035 of an existing MEC contract is very simple. Section 7702 (A)(a)(1) provides that once a contract is a MEC, it is always a MEC. The taint of MEC status cannot be removed by an exchange.

A 1035 Exchange is simple enough, but it must be properly executed to avoid creating a taxable event for your client.

Benefits of a 1035 Exchange

There are numerous reasons why a 1035 Exchange may be in the best interest of the client. For example:

- The client may have a change in circumstances that warrants a change in insurance coverage;
- a policy may be underperforming;
- a policy is using outdated mortality tables;
- less expensive coverage is available.

Regardless of the reason, care should be taken to ensure that the exchange makes economic sense, it's done properly, and the client understands the ramifications of the transaction.

[1] With an annuity start date no later than the original.

Does the insured have to remain the same in a 1035 Exchange?

Yes, only contracts with the "same insured" can be involved in an exchange. The key in determining what types of exchanges will be permissible is understanding the purpose of the "same insured" requirement in the statute. The "same insured" language is intended to maintain the policy status quo. In other words, the transaction should leave the parties in the same position as they would have been in had the exchange not taken place.

FAQ: May two single life contracts insuring two different individuals be exchanged for one survivorship policy?
No. This type of exchange would defer the recognition of gain from a single life to the combined mortality of two lives, and therefore, does not meet the same insured requirements of Section 1035.

FAQ: May a survivorship policy be exchanged for two individual contracts on the same insureds and still qualify as tax free?
No.

FAQ: May a survivorship policy be exchanged for a single life policy in a situation where one of the joint insureds has passed?
Yes, in the event one of the insureds has predeceased the other, the IRS may allow such an exchange. In this scenario, the exchange would not alter when the benefits would be received. In two private letter rulings, PLR 9248013 and PLR 9330040, the IRS held that when a second to die policy was exchanged after the death of one insured for a policy insuring the survivor, the resulting new policy was an acceptable 1035 Exchange.

Planning Point

If acquiring a survivorship policy is critical to the overall planning strategy, the clients may wish to consider:

- Exchanging a single life policy for an annuity.
- Structuring the annuity to pay the premiums on the new survivorship policy.
- Whether the exchange would qualify as a permitted tax-free exchange under Section 1035.

With this approach, any gain in the contract would be deferred until payments are made from the annuity.

Does a 1035 Exchange have to be for the same type of policy?

No, one policy type can be exchanged for a different type of policy. The Code does not distinguish between the types of contracts involved in a Section 1035 Exchange as long as the guidelines outlined on page 1 are followed.

For example, in Revenue Ruling 68-235, a life insurance contract, an endowment contract and a fixed annuity were all exchanged for variable annuity policies. [2]

What about an exchange involving term insurance?

In some instances, there may be an opportunity to exchange a term contract for a cash value permanent contract or even an annuity contract. While this is not a common practice and may be possible in only limited situations, it may be worth discussing with the client's tax advisors. The advantage of this exchange is that some term policies may have a high cost basis even though they may have little or no policy value. If the new contract is surrendered at some point after the exchange, the carry-over basis from the term policy would enable the policy owner to receive proceeds

[2] Rev. Rul 68-235, 1968-1 C.B.360.

from the new policy as a return of basis. It is important to note that not all insurance carriers are able to facilitate this type of exchange. Consult with the surrendering carrier as well as the issuer of the new coverage to confirm their capabilities.

Can you exchange multiple policies for one policy?

The Code does not specifically address the issue of whether it is possible to exchange two or more policies on an individual's life for one newly issued policy on the same individual. As a result, life insurance professionals have to look for guidance in this area primarily from nonauthoritative sources such as Private Letter Rulings (PLRs).

The IRS has allowed the following types of Section 1035 Exchanges:

- Two life insurance contracts for one life insurance contract
- Two life insurance contracts for one annuity contract PLRs 9708016 and 9820018
- One annuity contract for one annuity with a term insurance rider PLR 200022003
- Two annuity contracts into one resulting annuity contract Rev. Rul 2002-75
- One annuity contract into two annuity contracts PLRs 200243047 and 9644016

If a client's individual situation does not fit into the situations outlined in these PLRs, the client should seek advice from tax counsel and may want to request a PLR for their situation.

Can you do a partial 1035 Exchange?

Yes, the rules regarding partial 1035 Exchanges of annuities are clear; however the IRS does not specifically address life insurance. **It is important to note, with either an annuity or a life exchange, carriers may be reluctant or unable to administratively accommodate a partial exchange. Both the surrendering and the accepting company should be consulted prior to initiating an exchange.**

Partial exchanges to annuities

Revenue Procedure 2011-38 provides the rules involving partial 1035 Exchanges of annuities. This Revenue Procedure replaces Revenue Procedure 2008-24. It simplifies and clarifies previous rules governing partial exchanges.

The new rules generally provide clarity and increased simplicity from a tax standpoint. Rev. Proc 2011-38 provides:

- The required holding period before a distribution may be taken from the contract has been shortened from 12 months to 180 days.
- A partial exchange from a deferred annuity to an immediate annuity is now expressly permitted.
- Payouts taken from the immediate annuity within 180 days will be allowed provided the payment method is either life-based or for a period of 10 years or more.

How is basis handled with multiple policies?

- The basis in the original contract needs to be split between the resulting contracts.
- In Notice 2003-11, the basis of the original annuity contract was prorated between the two new contracts.

Does the Death Benefit need to match?

This issue appears deceivingly simple. The Code does not require that the death benefit of the resulting policy match the value of the original contract.

However, care needs to be taken so that:

- The new policy's death benefit is sufficient relative to its cash values so that it continues to qualify as life insurance.
- No other property or cash is distributed as part of the exchange.

Partial exchanges to a life insurance policy

By comparison, there is no specific authority regarding partial exchanges of life insurance. The IRS is silent on this subject. There does not appear to be grounds to treat life insurance differently than annuities.

Can you do a 1035 Exchange with a policy that has outstanding loans?

Yes. However, even when an exchange qualifies as a Section 1035 Exchange, some amount of the policy may be taxable. This amount is generally referred to as "boot" or the value of additional money or property that falls outside the traditional Section 1035 Exchange. One common situation where "boot" may be recognized in the transfer is where the policy involved has an outstanding loan.

This situation is best illustrated by an example.

Example of an exchange with an outstanding loan

An insured has an old policy into which he has paid premiums of $250,000, resulting in the following values:

Current Contract	
Premiums Paid	$250,000
Death Benefit	$1,500,000
Cost Basis	$250,000
Cash Value	$400,000
Gain	$150,000
Loan	$150,000

What happens if the outstanding loan isn't carried over correctly?

If the insured initiates an exchange of this old contract for a new contract without carrying over the outstanding loan, the insured will recognize $150,000 of taxable income. This occurs because:

- The extinguished loan ($150,000) is considered boot as part of the transaction and is taxable to the extent of the gain ($150,000) in the policy.
- By not carrying over the loan, the taxpayer is treated as having had the loan forgiven and is not obligated to repay the $150,000 loan.
- To the extent there is gain in the policy, the taxpayer will have unexpected tax consequences.

Planning Point

If handled correctly, the taxpayer may end up with a new life insurance policy and no reportable income. There are two options to avoid having to recognize the "boot."

1. Pay off the loan prior to the exchange.
2. Transfer the loan to the new policy.

If handled incorrectly, the taxpayer will be subject to income taxation to the extent of any gain in the original policy if a life insurance policy with an outstanding loan is exchanged for another life insurance policy without the loan carried over correctly to the new policy.

How to correctly handle outstanding loans in a 1035 Exchange

In order to avoid having to recognize "boot," the taxpayer has two options. They can pay off the loan prior to the exchange or they can transfer the loan to the new policy:

Pay off the loan prior to the exchange.

There are generally two methods of achieving this result.

Policy owner repays loan from policy value. The policy owner may take a withdrawal up to the amount of basis from the policy in order to extinguish the loan.

- This approach should be used with caution. If the withdrawal is made in close proximity to the exchange, the IRS may determine that the two transactions were not intended to stand alone. PLR 8905004. The IRS may consider it a step transaction – which merges the surrender with the partial withdrawal resulting in taxable boot to the extent of gain in the contract. IRS Section 1031(b).
- If a partial withdrawal is going to be used, it is advisable to wait for an extended period of time after the partial surrender to implement the 1035 Exchange.
- If the old contract involves dividends, consideration should be given to waiting for the policy anniversary and taking the dividend in cash. The cash proceeds would be considered the policy owner's own funds and could be used to pay down the loan.

Policy owner repays loan with separate and distinct funds. This is the preferred method of paying off a loan because it uses funds that are separate and distinct from the policy's cash value. This should ensure that the loan repayment will stand on its own and the transfer will not trigger any adverse tax consequences.

  - The policy owner may subsequently take out a new loan from the resulting policy in order to recover the funds previously transferred.

Transfer the loan over to the new policy.

The issues associated with extinguishing a policy loan can be avoided entirely if the new policy is issued with an outstanding loan. It has become common practice with insurance carriers to permit policy holders to "roll over" existing loans, provided the outstanding loan does not violate the company's rules regarding maximum allowable first year loans. The IRS has indicated in several private letter rulings that this kind of transfer will constitute a valid 1035 Exchange. See PLR 8806058, PLR 8604033, PLR 8816015

  - It is important to clearly understand how the new contract's policy loan provisions work and how the death benefit may be affected by the outstanding loan before choosing to go with this approach.

Can the owner take withdrawals prior to or after a 1035 Exchange?

Yes, however withdrawals may create adverse tax consequences. Running afoul of the "boot" recognition rules is not solely a problem involving loans on an insurance contract.

Withdrawing cash value immediately before or after an exchange may also cause unforeseen and unwanted tax consequences. This conclusion was asserted by the Internal Revenue Service in Private Letter Ruling 8905004.

Tax rules regarding withdrawals not applicable to 1035 Exchange

The general tax rules involving life insurance are contained in Section 72 of the Code.

- These rules permit an owner of a life insurance contract to withdraw policy cash values up to the basis in the contract without recognizing gain.
- The owner gets to recover the basis in the policy while leaving the gain untouched inside. **This rule, however, is not applicable in a 1035 Exchange.**

In coming to this conclusion, the Service noted that the withdrawal rules of Section72 cannot be used to get around the boot recognition rules contained in other sections of the Code, specifically Sections 1031(b) and 1035.

- **Under Section 1031(b),** if an exchange would have qualified for tax-deferred treatment under Section 1035 but for the receipt of "other property or money" in addition to the like-kind property, then generally, the exchange will still qualify, but the additional property is considered "boot" to the policy owner. Section 72 is disregarded, and the boot is taxable to the owner to the extent of gain in the original insurance contract.
- **Step-Transaction Doctrine** - Withdrawals that are taken before or after an exchange may be viewed as interrelated steps and may cause the policy owner to recognize income to the extent of the gain in the contract. The Service has applied the step-transaction doctrine to such situations. It views the cash withdrawal in conjunction with the exchange as part of an orchestrated plan to achieve an intended net result and, therefore, should be collapsed and treated as a single transaction. The Service has applied the step-transaction doctrine to withdrawals before and after an exchange.

Advice from tax counsel should be sought if withdrawals are contemplated in connection with an exchange of contracts.

Planning Point

To avoid the appearance that the withdrawal and exchange were not intended to stand on their own, care should be taken to ensure the two transactions are not construed or otherwise interpreted to be part of an overall plan or design.

There is no indication from the Service at this point as to how much time should lapse between the withdrawal and the exchange in order to avoid having the transactions collapsed.

Can a policy in a Split-Dollar Plan be exchanged?

Post-2003 Split-Dollar Plans

Any new arrangements entered into after the effective date of Revenue Bulletin 2003-46 do not present any special issues with respect to which tax treatment will govern the arrangement. Accordingly, taxpayers looking to exchange one policy for another policy would simply follow the normal 1035 rules.

The same cannot be said for 1035 Exchanges involving pre -2003 arrangements.

Pre-2003 Split-Dollar Plans

Plans established before 2003 are considered grandfathered. This permits those arrangements to follow the previous tax treatment.

- *An exception to that rule exists for any plan that experiences a "material modification."* These plans would no longer be grandfathered and would be subject to the new rules. The IRS does not specifically address if a 1035 Exchange is considered a material change. Therefore, a 1035 Exchange may trigger the plan to lose its grandfathered status and be subject to stricter, post-2003 tax treatment.

Almost 10 years have passed since the IRS issued Revenue Bulletin 2003-46, which significantly changed the way Split-Dollar Plans are taxed. Any plans entered into or "materially modified" after September 17, 2003 must follow the stricter, less-favorable rules.

What is a "material modification" of a Split-Dollar Plan?

Unfortunately, there has been little guidance by the IRS. In the final split-dollar regulations, only "nonmaterial" changes have been addressed. These consist of mostly ministerial, administrative or nondiscretionary modifications. *What is noticeably absent is any clarification concerning 1035 Exchanges.*

- Some experts in this field believe the IRS should test each 1035 Exchange subject to the grandfathered split-dollar rules on a case-by-case basis. The analysis would be to determine if the 1035 Exchange significantly affects the economics of the policy or the parties to the split-dollar agreement resulting in a material modification.
- Others believe the omission of 1035 Exchanges from the list of nonmaterial modifications results in a practical determination that the IRS intended it to be considered a material modification.

Without further additional guidance, advisors should carefully review the potential tax consequences and risks associated with an exchange of a grandfathered Split-Dollar Plan.