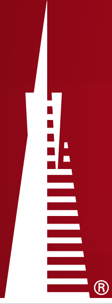

Advanced Matters

Section 1035 Exchanges

The IRS allows for life insurance contracts to be "exchanged" on a tax-free basis in what's called a Section 1035 exchange.

Without Internal Revenue Code (IRC) §1035, a policy owner or annuitant wanting to replace a current contract would have to surrender the original contract and then place the funds received into the new contract. Surrendering the original contract could result in a taxable gain if the surrender proceeds are greater than the owner's basis in the contract.

The main goal of a §1035 exchange is to allow the replacement of a life insurance or annuity contract without a taxable gain. The contract owner should avoid receipt of funds from the contract in order to keep the tax-free status of the exchange, and arrive at the same basis in the new contract (IRC §1031(d)).

Requirements to qualify for a IRC §1035 exchange

- The exchange must be a permissible exchange (see table below).
- Insured/annuitant must be the same on both policies.
- Owner must be the same on policies.

What can be exchanged?

Type of Contract	Permissible Exchanges
Life insurance contract	• Another life insurance contract • Life insurance or annuity contract with a qualified long term care rider • Annuity contract • Endowment insurance contract • Qualified long term care contract
Annuity contract	• Annuity contract • Annuity contract with a qualified long term care rider • Qualified long term care contract
Endowment contract	• Another endowment contract, with a required beginning date not later than the original contract • Annuity • Qualified long term care contract
Qualified long term care contract	• Qualified long term care contract
Modified Endowment Contract (MEC)	• MEC • Annuity contract • MEC or annuity with a qualified long term care rider • Qualified long term care contract

- Any type of permanent life insurance policy can be exchanged for another permanent life insurance policy.
- IRC §1035 now allows for a life insurance contract to be exchanged for a qualified long term care contract or a life insurance contract with a qualified long term care rider. Also, annuities can be exchanged for a qualified long term care contract or another annuity with a qualified long term care rider.

Exchanges that are not allowed

- Annuity contract for life insurance.
- Joint life insurance contract for a single life insurance contract (unless only one insured is still living).
- Single life insurance contract for a joint life insurance contract.

Special Considerations

- MECs
  - A modified endowment contract (MEC) is a policy entered into after June 21, 1988 that fails the 7-pay test. (See IRC §7702A)
  - A MEC may also be created through a §1035 exchange if the requirements of a sec. 1035 exchange are not met.
  - §1035 exchanges are allowed from a MEC; however the new contract will also be a MEC, conforming to the rule "once a MEC, always a MEC."
  - One strategy is to exchange the MEC policy for a qualified long term care contract or a life insurance contract with a qualified long term care rider, providing possible tax-free long term care benefit payments.
- Exchanging multiple policies for one policy
  - Multiple policies may be exchanged for one policy in one integrated exchange transaction
- Foreign policies
  - A United States life insurance contract cannot be exchanged under sec. 1035 for a life insurance contract issued by a foreign company.

Exchanges resulting in taxable "boot"

IRC §1031(b) states that any property other than the allowed policies, or "boot", received in the exchange will be taxable to the extent of gain in the contract. Two situations which commonly cause the contract owner to end up with a taxable gain are outstanding policy loans and policy withdrawals.

- Outstanding policy loans
  - A policy loan can be repaid with outside funds before the exchange takes place. This will preserve the tax-free nature of the exchange.
  - Repayment of the loan from policy cash values as a part of the exchange can be taxable. The policy owner will have been considered to have received "boot" and will be taxed on the loan paid from cash value to the extent of gain in the contract under IRC §1031(b).
  - A policy loan may be carried over to the new insurance contract without causing taxable gain on the exchange if accepted by the receiving company.

The following is an example of the tax implications that result from a loan being paid back from cash value from the original policy during the exchange.

	Old Policy	Old Policy after loan is repaid	New Policy after exchange
Basis	$5,500	$5,500	$5,500
Cash Value	$10,000	$7,500	$7,500
Policy Loan	$2,500	$0	$0
Gain	$4,500	$2,000	$2,000
Taxable Boot	$0	$2,500	$0
Withdrawal	$0	$0	$0

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The $2,500 policy loan was paid from the $10,000 policy cash value as part of the sec. 1035 exchange. The owner has received "boot" of $2,500 and will be taxed to the extent of gain in the policy. In this example, the entire $2,500 will be taxable as ordinary income.

- Withdrawals immediately before or after exchange
  - A withdrawal from a contract immediately before or after an IRC §1035 exchange may result in the withdrawal being treated as taxable "boot" under IRC §1031(b).
  - The withdrawal, if boot, is taxable to the extent of gain in the contract.
  - The IRS may apply the step transaction doctrine to treat the withdrawal and subsequent exchange as one transaction. There is no clear guidance on how long the owner should wait before attempting a withdrawal in conjunction with an IRC §1035 exchange.

The following is an example of a withdrawal from a policy immediately before an exchange.

	Old Policy	Old Policy after withdrawal	New Policy after exchange
Basis	$4,000	$0	$3,000
Cash Value	$7,000	$3,000	$3,000
Policy Loan	$0	$0	$0
Gain	$3,000	$3,000	$0
Taxable Boot	$0	$3,000	$0
Withdrawal	$4,000	$0	$0

Normally, a withdrawal from cash value will come from basis first for a non-MEC policy. In this example, the entire $4,000 would be considered a return of basis if there was no exchange or the step transaction doctrine does not apply. Upon a subsequent exchange, if the step transaction doctrine applies, the $4,000 withdrawal is taxable to the extent of the gain in the contract. Therefore, $3,000 will be taxable and only the remaining $1,000 will be a return of basis.

In 1954, the same year IRC §1035 was enacted, a House Committee Report stated that IRC §1035 was enacted to avoid taxing individuals "who merely exchanged one insurance policy for another better suited to their needs, but who have actually not realized gain." A §1035 exchange can be a beneficial process for life insurance and annuity owners to allow for continued deferral.

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