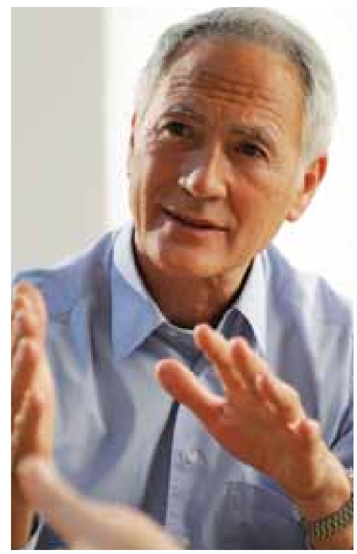
Total Financial & Insurance Services, Inc.
(800) 989 - 7500
www.totalfinancial.com



1035 Exchanges:

Requirements, Benefits and Planning Considerations

Overview of 1035 Exchanges

Internal Revenue Code (IRC) § 1035 provides advisors and their clients significant flexibility to modify existing contracts as needed to adapt to changing circumstances and to take advantage of new product developments.

Legislative history indicates § 1035 is intended to permit the deferral of taxation for individuals who "merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain."[1] That means, in general, no gain or loss is recognized on the exchange of one contract for another – referred to as a "1035 exchange" – as long as certain conditions are met.

This guide provides a review of 1035 requirements, benefits and planning considerations.

1035 Exchange Requirements

To qualify for tax-free exchange treatment, both the owner and the insured of the new life insurance contract must be the same as the owner and insured of the surrendered life insurance contract.[2] Keep in mind that 1035 exchanges are permitted only if the exchange does not delay the receipt of benefits by the taxpayer. Common scenarios illustrating the application of the "same insured" requirement of 1035 exchanges are demonstrated by the following:

Second-to-die to Single Life

In two private letter rulings, PLRs 9248013 and 9330040, the Internal Revenue Service (IRS) noted that when a second-to-die policy was exchanged after the death of one insured for a policy insuring only the survivor, the new policy was insuring the same single life and thus was an acceptable 1035 exchange.

Single Life to Second-to-die

The exchange of two single life policies for one survivor life policy does not conform to the same insured requirements of § 1035. Similarly, one survivor policy cannot be exchanged for two single life policies. In PLR 9542037, the IRS concluded that exchanges involving policies insuring a single life for a policy insuring two lives does not qualify for nonrecognition treatment under IRC §1035. In the letter ruling the IRS sets forth five examples, none of which qualify for nonrecognition treatment because the insured(s) in the old contract are not identical to the insured(s) in the new contract:

- Spouse A exchanges a policy insuring only his life for a policy that insures the lives of both Spouse A and Spouse B.
- Spouse A exchanges two life insurance policies, one that insures Spouse A and another that insures Spouse B, for a single second-to-die policy insuring the lives of both Spouse A and Spouse B.
- Spouse A and Spouse B jointly exchange separate policies, each of which insures the life of one spouse for a single jointly owned second-to-die policy that insures the lives of both Spouse A and Spouse B.
- A trust owns and exchanges a policy insuring the life of Spouse A for a policy that insures the lives of both Spouse A and Spouse B.
- A trust owns and exchanges two life insurance policies, one of which insures Spouse A and the other of which insures Spouse B for a single second-to-die policy insuring the lives of both Spouse A and Spouse B.

Life Insurance to Annuity

When exchanging from a life policy to an annuity, the annuitant must be the same as the insured on the old life policy. If exchanging from an annuity to another annuity contract, the “obligee” in the new annuity contract must be the same as the “obligee” in the surrendered annuity contract. The meaning of the term “obligee” is somewhat uncertain and could mean the owner or the annuitant. As a result, many carriers require the owner and annuitant to remain the same in the new contract as they were in the old contract. This question of whether you can exchange a single life insurance contract for a joint and survivor annuity has not been addressed directly. Arguably, the owner could accomplish the result by exchanging the life policy for an annuity listing only the insured as the annuitant. At some point later, the owner could change the annuity to a joint and survivor annuity (assuming the contract so allowed).

Policy Split-option Rider

A policy split-option rider does not circumvent the same insured requirements of IRC § 1035. Instead, such an approach is treated as a taxable sale of the policy under IRC §1001 rather than a tax-free exchange.[3]

A number of questions surrounding the requirements of 1035 exchanges deserve mention, including:

- **Type of policy.** The IRC does not distinguish between types of permanent contracts (e.g., variable universal life, whole life or universal life) for 1035 exchange purposes.[4,5]

- **Death benefit.** Nonrecognition treatment does not require that the values of the policy acquired be the same or similar to the values in the policy exchanged.[6] As such, the death benefit on the acquired policy may be either more or less than the death benefit of the exchanged policy.[7]

- **Number of contracts.** Just as IRC § 1031 applies to like exchanges of multiple business or investment properties, IRC § 1035 applies to exchanges of multiple life insurance and annuity contracts.[8] Examples of transactions receiving nonrecognition that otherwise met the requirements of IRC § 1035 (i.e., same insured/owner) include:

    - Two life insurance contracts for one life insurance contract
    - Two life insurance contracts for one annuity contract[9]
    - Consolidation of two existing annuities into one[10]
    - One annuity contract for two annuity contracts[11]
    - One annuity contract for one annuity with a term insurance rider[12]

Benefits of a 1035 Exchange

The primary benefit of a 1035 exchange is that no gain is recognized on the surrender of the contract.[13] The new contract retains the tax basis of the old contract. While a large lump sum paid into a life insurance contract may cause a new life insurance contract (new policy) to be a modified endowment contract (MEC), that is generally not the case with a lump sum deposited in a new policy via a 1035 exchange.[14]

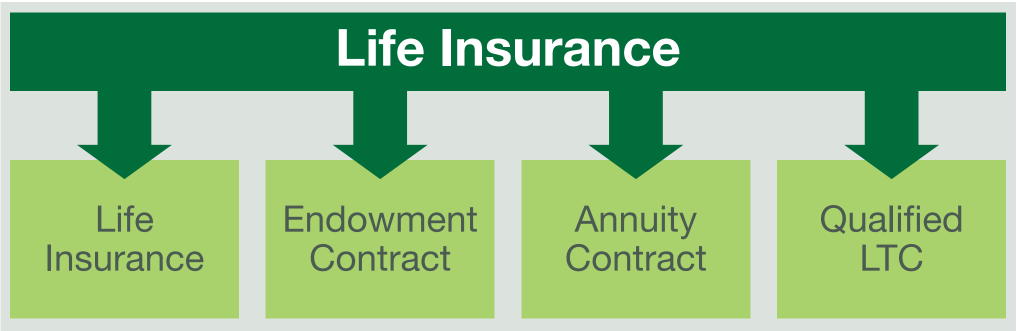
A number of tax issues with the new policy deserve consideration:

- If the 1035 exchange is done during the first seven years of the original policy, a reduction in death benefit may trigger MEC status.
- Future premium payment into the new policy must satisfy the "7-pay test."
- After the exchange, a new 15-year period starts for forced-out gain purposes under IRC § 7702(f)(7). Forced out gain is the taxable income that may result if cash is withdrawn from the policy and the death benefit is reduced during the first 15 policy years.

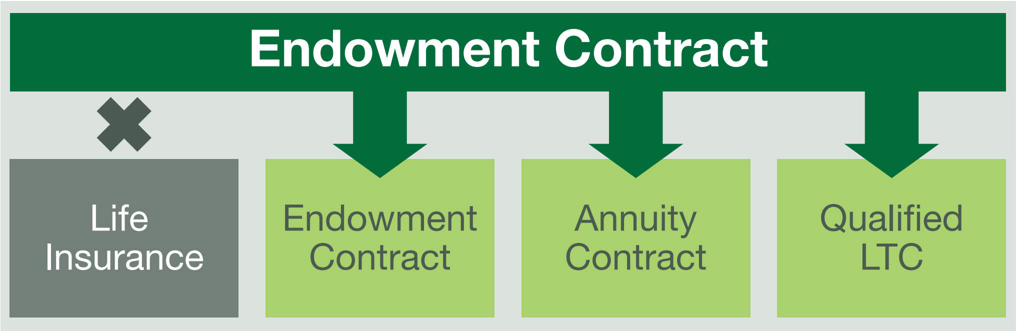
Types of Exchanges Allowable

IRC § 1035 provides that no gain or loss is recognized on the exchange of the following:

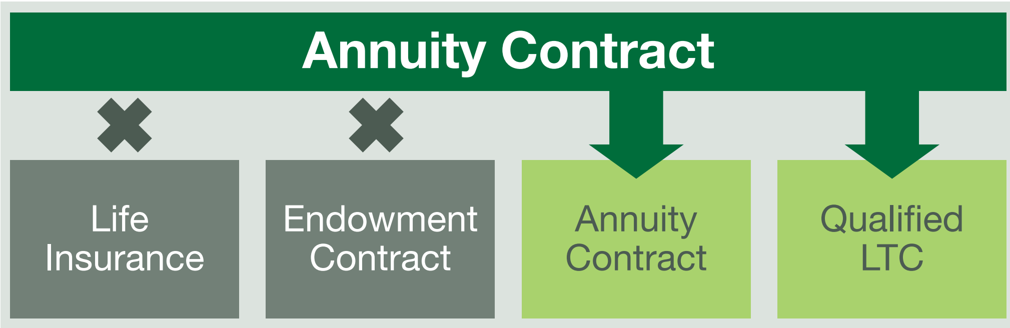
- A life insurance contract for another life insurance contract, endowment contract, annuity contract or qualified long-term care (LTC) contract.[15]



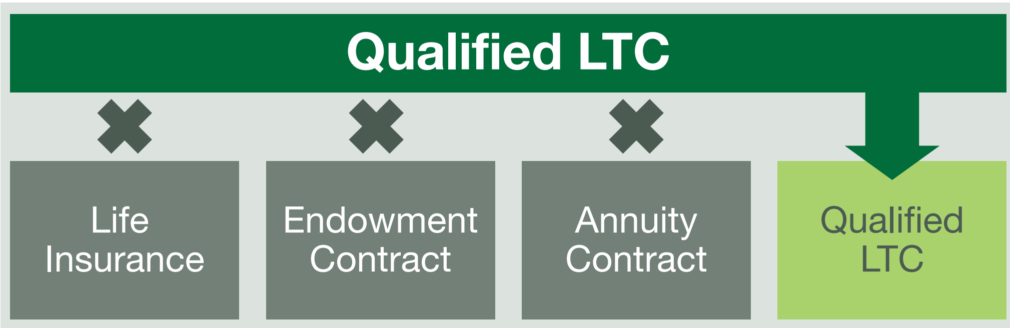
- An endowment contract for another endowment contract (with an annuity start date no later than the original), annuity contract or qualified LTC contract.[16]



- An annuity for another annuity or qualified LTC contract.



- A qualified LTC contract may be exchanged tax-free for a qualified LTC insurance contract.



Exchange of Life Insurance Policy with Outstanding Loan Balance

When a life insurance policy with an outstanding policy loan is exchanged for another life insurance policy, the loan is considered “boot” and subject to income taxation to the extent of any gain in the original policy, unless the loan is carried over to the new policy.[17] If the loan is paid off before the exchange using cash values from the original life insurance policy, the IRS may apply the step transaction doctrine and regard the payment of the loan and the 1035 exchange as one integrated transaction.[18] As a result, the extinguished loan is treated as boot.[19] The safer approach may be to pay the loan using funds from sources other than the life insurance policy that is being exchanged. This fact pattern can best be demonstrated by the following example.

Situation

Insured has an old $500,000 whole life policy with Old Life Company that he would like to 1035 exchange for a new universal life policy with New Life Company. The policy has a gross cash value of $150,000 and a policy loan of $50,000 (thus, the net cash value is $100,000). Cumulative premiums (i.e., basis) paid are $75,000, so the policy has $75,000 of gain. The insured intends to transfer just the net cash value to the new policy and not carry over the policy loan.

Problem

If the insured goes through with this exchange, he will incur $50,000 of taxable income. This is because the extinguished loan ($50,000) is considered boot as part of the exchange and is taxable to the extent of gain ($75,000) in the policy. The insured is in effect exchanging a policy with a gross cash value of $150,000 for a policy with a gross cash value of $100,000. Instead of receiving $50,000 of cash as part of the exchange, which virtually everyone would clearly identify as boot, the insured is relieved of his obligation to repay the $50,000 policy loan. Many policyowners are unaware of this tax trap until they receive a 1099 from the insurance company, at which point it is too late to correct the problem.

Solutions

- **Pay off the loan prior to the exchange.** This should generally be done using the policy owner’s own out-of-pocket funds. It may be possible for the policy owner to take a withdrawal of basis from the policy in order to repay the loan. However, if this is done in close proximity before the exchange, the IRS may consider it a step transaction and attempt to assert that there is taxable boot. The IRS may consider a partial surrender made prior to an exchange in order to extinguish a loan as part of the exchange if it can be shown that the policy holder did not intend the surrender to be an isolated transaction.[20] Accordingly, a partial surrender made pursuant to retiring a policy loan prior to a nontaxable exchange may be collapsed into that exchange, resulting in the receipt of taxable boot to the extent of gain in the policy. In a whole life contract with dividends, if the policy anniversary is close, 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 out-of-pocket funds and could be used to pay down the loan.

- **Transfer the loan as part of the exchange.** The IRS has indicated in several private letter rulings (see PLRs 8806058, 8604033 and 8816015) that the exchange of a policy with an outstanding loan for another policy subject to the same indebtedness constitutes a valid 1035 exchange. If the policy owner waits a reasonable amount of time (one year is generally advisable), the policy owner can later eliminate the loan on the new policy by taking a withdrawal of basis and using it to repay the loan.

Grandfathered Split-dollar Arrangements and 1035 Exchanges

For a variety of reasons, the parties to a grandfathered split-dollar arrangement (SDA) may wish to exchange the original policy for another in a 1035 exchange. For example, the original policy may have experienced poor performance, such that it can no longer support the original needs of the insured or may hinder the ultimate repayment to the employer (or other premium payor).

Unfortunately, the complete lack of IRS guidance as to what constitutes a "material modification" raises substantial uncertainty about the impact of a 1035 exchange on a grandfathered SDA. The "non-material" modifications listed in the final split-dollar regulations (SD regulations) are generally ministerial, administrative or nondiscretionary in nature. Notably, even though comments to the proposed SD regulations requested that the IRS include 1035 exchanges as non-material modifications, the final SD regulations failed to do so.[21]

Some commentators have suggested that the IRS could test 1035 exchanges of policies subject to grandfathered SDAs on a facts and circumstances basis,[22] potentially considering whether the 1035 exchange significantly affects the economics of the policy or the parties to the SDA. Without additional guidance, however, it is difficult to generalize what the IRS would consider a significant economic change for purposes of a material modification.

Further, some practitioners believe the omission of a 1035 exchange from the list of non-material modifications implies that the IRS considers it a material modification.[23] Thus, there is no certainty that the IRS will adopt a facts and circumstances test over a hard-and-fast rule that all 1035 exchanges are material modifications for SDA purposes. Accordingly, until the IRS issues further guidance, the risk exists that a 1035 exchange of a policy subject to a grandfathered SDA will materially modify the arrangement and result in the loss of grandfathered status.

Advisors recommending a 1035 exchange of a life insurance policy subject to a grandfathered SDA should carefully evaluate the risk that the exchange will be a material modification that results in the loss of an SDA's grandfathered status. Such a change in status, however, may not be detrimental in every situation, and advisors must consider the particular facts and circumstances of each case. Likely, the major determining factor will be whether the grandfathered SDA has an equity component, and whether the policy has significant equity build-up that may become taxable to the employee if a material modification of the grandfathered SDA occurs. For example, where an exchange is contemplated because a policy is underperforming, equity buildup may not be an issue.

Regardless, each case will warrant an analysis of the potential tax consequences of a material modification; the client's current coverage and premium funding requirements; income and gift tax consequences of future premium payments or the measure of annual economic benefits provided; and the options for a current or subsequent exit of the arrangements.

Additional 1035 Exchange Planning Considerations

Modified Endowment Contracts

A number of questions surrounding 1035 exchanges and MECs deserve mention, including:

- If a life insurance contract being exchanged is a MEC, the new policy will also be a MEC.[24]
- Where multiple life policies, including one MEC, are exchanged for a single life policy, the new policy may be a MEC because one of the policies exchanged was a MEC.
- All MECs issued by the same carrier to the same policy owner will be treated as a single MEC.[25]
- Note that life insurance policies issued prior to June 21, 1988, including those labeled single premium whole life, were grandfathered and not subject to the modified endowment rules of IRC § 7702A. However, the exchange is a material exchange. As a result, additional premium payments into the new policy must satisfy the "7-pay test" to avoid MEC status.

Split 1035 Exchanges

A split 1035 is a 1035 exchange in which the entire value of one contract is split among two or more receiving carriers and two or more policies. There is no authority prohibiting a split 1035. Rather, a split 1035 exchange would appear to qualify for nonrecognition treatment under 1035. However, carriers may be reluctant, unwilling or unable to accommodate such a request.

Partial 1035 Exchanges

A partial exchange of an annuity is allowed. *Conway v. Comm'r,* 111 T.C. No. 20 (1998); Rev. Proc. 2011-38; Rev. Proc. 2008-24. Rev. Proc. 2011-38 establishes a general rule that any partial exchange of annuity contracts that falls within the guidelines set out in the procedure will be treated as a tax-free exchange under IRC § 1035, as long as no amount is received under either the original or the new contract (except amounts received as an annuity for one or more lives or for a period of 10 years or more), during the 180 days beginning on the date of the transfer (or, in the case of a new contract, the date the contract is placed in force). A later direct transfer of all or a portion of either contract involved in such an exchange will not be taken into account for purposes of applying these rules, if that subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange under IRC § 1035. The basis of the original annuity contract is prorated between the two new contracts. IRS Notice 2003-51.

There is no specific authority authorizing or prohibiting a partial exchange of a life insurance policy from receiving nonrecognition treatment under §1035. There does not appear to be policy grounds to treat life insurance differently than annuities. As with other split 1035 structures, carriers may be reluctant, unwilling or unable to accommodate such a request.

Long-term Care Insurance (LTCI)

To receive nonrecognition treatment, IRC § 1035 requires the entire value of the existing contract (e.g., life insurance, annuity, etc.) to be paid into the new LTCI contract. If the cash value from an existing contract is larger than the LTCI premium, the existing contract should be only partially exchanged, or the LTCI contract should accept a larger premium (i.e., limited pay policy) or a combination thereof.

Foreign Contracts

A 1035 exchange involving a contract issued by a foreign insurance company qualifies for nonrecognition treatment under § 1035 provided the existing contract meets the definition of life insurance or an annuity under U.S. federal income tax law.[26]

Footnotes

[1]H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 81 (1954).

[2] I.R.C. § 1035; Treas. Reg. § 1.1035-1(c); Treas. Reg. § 1.1035-(c); Rev. Rul. 90-109, 1990-2 C.B. 191.

[3] Rev. Rul. 90-109.

[4] For example, in Rev. Rul. 68-235, a taxpayer exchanged a life insurance contract, an endowment contract and a fixed annuity (prior to maturity) for three variable annuity policies. Rev. Rul. 68-235.

[5] No guidance exists from the IRS as to whether a term policy can be exchanged for a permanent policy. A term conversion is not a 1035 exchange. As such, the owner's basis in the term contract would not carry over to the new permanent contract acquired by exercise of a conversion right in the term contract. Some commentators believe 1035 exchange treatment could result from the transfer of existing cash values into a policy created under a term conversion.

[6] Priv. Ltr. Rul. 98-20-018 (Feb. 11, 1998) ("[N]onrecognition treatment under section 1035 is not expressly conditioned upon the relative policy values of the policies exchanged, so long as no other property or cash is distributed as part of the exchange. Rev. Rul. 92-43, 1992-1 C.B. 288"). Similarly, a new contract may have a different guaranteed investment rate than the original contract. PLR 8442010 (July 3, 1984).

[7] The acquired policy's death benefit must be sufficient relative to its cash values in order to qualify it as life insurance under IRC § 7702 in order to preserve certain tax benefits available, including an income-tax-free death benefit.

[8] See, e.g., IRC § 7701(m)(1), which cross-references Title 1 of the United States Code, which in turn provides that "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise, words importing the singular include and apply to several persons, parties, and things."

[9] See, e.g., PLR 9708016 and PLR 9820018.

[10] See, e.g., Rev. Rul. 2002-75, 2002-45 IRB 812 (2002). The taxpayer's basis in the new annuity will equal his combined basis in both consolidated contracts. In this ruling, the taxpayer consolidated the two existing annuities into one; there was no new annuity issued as part of the transaction.

[11] See, e.g., PLRs 200243047 and 9644016.

[12] See, e.g., PLR 200022003.

[13] Determination of the basis of property acquired in an exchange under IRC § 1035(a) shall be governed by IRC § 1031(d) and the regulations thereunder. Treas. Reg. § 1.1035-(c).

[14] As defined in IRC § 7702A, a modified endowment contract (MEC) is a life insurance policy in which the cumulative premium payments in any one of the first seven policy years exceed the sum of the net level premiums, which would have been paid to provide a paid-up policy after the payment of seven level annual premiums (the "7-pay test"). Distributions from a MEC, either a withdrawal or loan (or use of the policy as collateral for a loan), are taxed to the extent there is a gain in the policy. Also, a 10 percent penalty will be assessed on the taxable amount of any distributions made prior to the policy owner's attaining age 59 ½, unless the policy owner is disabled or receives the cash value under a life annuity settlement option. Note, however, that the 10 percent penalty tax is always applicable if the policy owner is a "non-natural" person (e.g., a corporation or trust). If there has been a "material change" in the terms or benefits of the policy, the 7-pay test will be applied as if the policy was a new contract at the date of the material change. Generally, once a policy is a MEC it is always a MEC. However, if premiums in excess of the 7-pay limit are paid, the MEC rules will not apply if such premium payments, plus interest (which is taxable), are returned to the policy owner within 60 days after the end of the policy year in which the excess premium payment was made.

[15] Under Section 1035, a life/LTCI combination product is treated as life insurance and an annuity/LTCI contract is treated as an annuity contract.

[16] Generally, endowment contracts are no longer issued by insurance carriers because they do not meet the Internal Revenue Code's definition of life insurance. Endowment contracts should not be confused with modified endowment contracts.

[17] § 1031(b)-1(c); see also Rev. Rul. 2003-56, and PLR 9141025.

[18] See e.g., PLR 8905004, in which the IRS applied the step-transaction doctrine to a withdrawal and subsequent 1035 exchange. As a result, both steps were treated as one transaction resulting in the withdrawal being treated as boot. No definitive guidance exists from the IRS as to the requisite amount of time required between the withdrawal and the 1035 exchange to avoid potential application of the step-transaction doctrine.

[19] § 1031(b).

[20] See, e.g., Priv. Ltr. Rul. 91-41-025 (Oct. 15, 1991). Under the step-transaction doctrine, all steps taken pursuant to a unitary plan to achieve an intended result are viewed as a single transaction.

[21] See, Lawrence Brody, Michael D. Weinberg and Myron Kove. "Practice Alert: Experts' Critical Analysis of Final Split-Dollar Regulations." *Estate Planners Alert Newsletter*. Dec. 2, 2003. ("Although the industry requested that 1035 exchanges be classified as non-material, the government chose not to address this issue in the regulations.")

[22] *See, e.g.*, Howard M. Zaritsky and Stephan R. Leimberg. "¶6.05. Split-Dollar Life Insurance," Tax Planning with Life Insurance: Analysis With Forms, WG&L Estate Planning Treatises. ("It is likely,
however, that the IRS will not consider every Section 1035 exchange to be a material modification and will test on a facts and circumstances basis.")

[23] *See, e.g.*, Lawrence Brody and Richard L. Harris. "Private Split-dollar Arrangements." *Trusts and Estates Magazine*. May 1, 2010. ("One of the things specifically not included as not being a material modification is an IRC Section 1035 exchange from an old policy into a new one (so, by inference, this type of exchange is a material modification)); Charles L. Ratner and Stephan R. Leimberg, "A Planner's Guide to Split-Dollar After the Final Regulations." *Estate Planning Journal*. January 2004. ("The replacement of the insurance policy in the split-dollar agreement with a new policy (e.g., a Section 1035 exchange) is not in the approved list. The implication is that such a change may trigger the much more restrictive and harsh post-9/17/03 final Reg. rules.")

[24] Section 7702(A)(a)(1) provides a MEC is a contract received in exchange for a MEC ("once a MEC, always a MEC").

[25] Section 72(e)(12)(A).

[26] *See e.g.*, PLR 9319024.

About NFP

NFP's benefits, insurance and wealth management businesses provide a broad range of advisory and brokerage services to companies and individuals, helping them preserve their assets and prosper over the long term. Our advisors partner with clients to help provide client-focused and comprehensive solutions, backed by NFP's national scale and resources.
NFP is a leader in the delivery of benefits solutions for companies of all sizes and in the delivery of life insurance and wealth management solutions for high net worth individuals. Our leading, independent broker/dealer offers a broad range of options from some of the nation's top investment companies.

Partner. Preserve. **Prosper.**™

NFP™ Benefits Insurance Wealth Management