ADVANCED MATTERS

SECTION 1035 EXCHANGES

The IRS allows for life insurance or annuity contracts to be "exchanged" on a tax-free basis in what's called a Section 1035 exchange. Provided that the rules are followed, this type of exchange allows for the replacement of a life insurance or annuity contract without a taxable gain.

REQUIREMENTS TO QUALIFY FOR AN IRC §1035 EXCHANGE

- The exchange must be a permissible exchange (see table below)
- Insured/annuitant must be the same on both contracts
- Owner must be the same on both contracts
- To keep the exchange tax free and arrive at the same basis in the new contract (IRC §1031(d)), the contract owner should not take receipt of the funds from the contract

WHAT CAN BE EXCHANGED?

IRC §1035 states that no gain or loss will be recognized on the following exchanges:

A life insurance contract for another life insurance contract, endowment insurance contract, an annuity contract, a qualified long term care (QLTC) contract, or a life insurance contract or annuity contract with a QLTC rider.

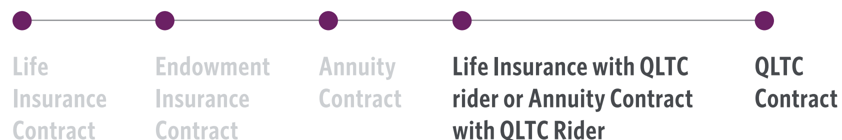
Life Insurance Contract

An annuity contract for another annuity contract, a QLTC contract, or an annuity contract with a QLTC rider.

Annuity Contract

A QLTC contract for another QLTC contract, or life insurance contract or an annuity contract with a QLTC rider.

Qualified Long Term Care (QLTC) Contract



An endowment insurance contract for another endowment insurance contract, an annuity contract, a QLTC contract, or an annuity contract with a QLTC rider.

Endowment Insurance Contract

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EXCHANGES THAT ARE ALLOWED

- Any type of permanent life insurance policy can be exchanged for another permanent life insurance policy or for a term life insurance policy
- Multiple life insurance policies and/or annuities may be exchanged for a single policy in one integrated exchange transaction
- With regard to a survivorship policy, following the death of one of the insureds, the insured survivor may exchange the survivorship policy for a single life policy on the survivor
- Any type of permanent life insurance or annuity can be exchanged for an annuity
- Inherited non-qualified annuities can be exchanged for new annuities provided that the special rules for inherited annuities are followed

MODIFIED ENDOWMENT CONTRACT (MEC)

- A modified endowment contract (MEC) is a policy entered into after June 21, 1988, that fails the 7-pay test. (See IRC §7702A)
- An MEC may also be created through an exchange of life policies if the requirements of a §1035 exchange are not met
- §1035 exchanges are allowed from an MEC; however, the new contract will also be an MEC, conforming to the rule, "once an MEC, always an MEC" (see IRC §7702A(a)(2))
- A life insurance contract that is considered an MEC may be exchanged for another MEC, an annuity contract, a QLTC contract, or an MEC or annuity contract with a QLTC rider

EXCHANGES THAT ARE NOT ALLOWED

- Annuity contract for life insurance contract
- Survivorship life insurance contract for a single life insurance contract or annuity (unless only one insured is still living)
- Single life insurance contract for a survivorship life insurance contract

EXCHANGES RESULTING IN TAXABLE "BOOT"

IRC §1031(b) states that any property other than the allowed policies received in the exchange is "boot" and will be taxable to the extent of gain in the contract. Two situations that 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 be considered to have received the cash value used to repay the loan as "boot" and will be taxed on the boot 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 the receiving company issues its contract subject to the same amount of loan
- If a partial surrender of a life insurance contract to extinguish part or all of any outstanding policy loan occurs at the same time as the exchange of policies, then the IRS may combine the two steps and treat the partial surrender as taxable boot to the extent of gain in the policy

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

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; this doctrine combines a series of formally separate steps, resulting in tax treatment as a single integrated 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.

In 1954, a House Committee Report explaining Sec. 1035 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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