Think About It

What every Financial Professional needs to know about

SECTION 1035 EXCHANGES

INTRODUCTION

One of the most important of all Code Sections relating to life insurance is Section 1035 – which enables the very important Section 1035 exchange. The key to the popularity of this provision is that – if arranged properly - the taxpayer can avoid recognition of any taxable gain from the disposition of an existing policy.

Section 1035 allows a client to trade one insurance policy for another without an immediate income tax result. A Section 1035 exchange is an incredibly valuable tool when used correctly.

What factors might cause a client to consider a Section 1035 exchange?

1. The new policy provides better benefits or investment performance than the existing one.

2. The cost to maintain the new policy is lower than that for the existing policy.

3. The new policy is more suited to the client's investment philosophy or insurance needs than the old one.

Section 1035 of the Code is deceptively simple. However, there are plenty of traps for the unwary financial professional. Any of the following missteps may lead to an undesirable result:

- Failing to follow the steps properly
- Attempting to complete an unapproved exchange
- Ignoring special rules

Our clients rely on us to guide them through the unique tax issues associated with the purchase of insurance products. They have a right to expect us to know when to implement Section 1035 exchanges to help them have those exchanges meet the letter of the law, and to sidestep potential minefields.

They also want us to make sure that the insurance carriers involved will treat the transaction as a proper Section 1035 exchange, and follow the steps necessary so that there are no unexpected problems or arguments with the IRS.

What Is A Section 1035 Exchange?

A Section 1035 exchange is a tax-free trade of an insurance policy for another. Its authority comes from Section 1035(a) of the Internal Revenue Code. That Code Section provides

Advanced Underwriting Consultants
www.advancedunderwriting.com
(615) 224-1291

Sec. 1035. Certain exchanges of insurance policies

(a) General rules

No gain or loss shall be recognized on the exchange of -

(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract or for a qualified long-term care insurance contract;

(2) a contract of endowment insurance

(A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or

(B) for an annuity contract, or

(C) for a qualified long-term care insurance contract;

(3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or

(4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.

So a life policy can be exchanged for an annuity contract, but *not* vice-versa. What is the rationale for that?

From a tax perspective, the government *allows* a tax-free trade of a *life policy* for an *annuity*, because it knows it will eventually collect income taxes from the annuity at the death of the taxpayer. A tax-free trade of an annuity for a life policy is *not allowed* because that might result in a loss of the IRS's opportunity to impose tax on annuity income because of the income tax free nature of life insurance death benefit.

The philosophy of Section 1035—at least traditionally--seems to favor allowing a tax free exchange of insurance products in those cases where the ultimate income tax result will be no worse for the government.

Long term care insurance benefits are generally income tax free, unlike the taxable annuity benefits, so why is an exchange of annuity for long term care insurance allowed?

The exchange for a long term care policy was only enacted in 2006, and has become effective this year. Its philosophy is in public policy. The federal government has recognized that there is an enormous potential unfunded liability for the cost of long term care for taxpayers. Washington has created a number of tax breaks for private long term care insurance (see the December 2009 issue of *Think About It*), and the relatively new 1035 provision allowing an exchange for a long term care policy is an incentive for individuals to accept responsibility for financing long term care insurance..

For the purpose of this article, we will concentrate primarily on exchanges of life for life, life for annuity, or annuity for annuity contracts.

Section 1035 also has a clarifying regulation that sheds a bit more light on its interpretation. Here is a helpful excerpt from subparagraph (c) of Regulation 1.1035-1:

> (*Section 1035 allows the exchange of an*) annuity contract for another annuity contract (section 1035(a) (3)), but section 1035 *does not apply to such exchanges if the policies exchanged do not relate to the same insured.* The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is *limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract.* This section and section 1035 *do not apply to transactions involving the exchange of an endowment contract or annuity contract for a life insurance contract, nor an annuity contract for an endowment contract.* In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section 1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031(b) and (c) and the regulations there under. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035(a) shall be governed by section 1031(d) and the regulations there under.

The regulation provides guidance to sort through some of the special tax considerations associated with Section 1035 exchanges.

Special Tax Considerations

Section 1035 requires that the parties to the exchange must be the same, both before and after the transaction. When exchanging a life policy for a life policy, it means that the policy owner and the *insured* must remain constant. See Rev. Rul. 90-109, 1990-2 CB 191.

It also means that the *taxpayer* attempting to accomplish the exchange must be the same for the old and the new contract.

The same kinds of requirements apply to annuity contracts. Both the owner and annuitant must be the same before and after the exchange.

Same Parties – Exchanging Life for Annuity

What about an exchange of a life policy for an annuity?

It seems clear that the policy owner of the life policy must be the same as the annuity to meet Section 1035's requirements. However, it is less clear whether the annuitant must be the same as the insured.

In general, the death benefit under an annuity contract is payable on the death of the policy owner. The annuity contract *may* also provide that a benefit is paid on the death of the annuitant. So, would the IRS make an objection to a Section 1035 exchange if the annuitant is different from the insured under the life policy? Should it? We are not sure.

Same Parties – Exchanging Life Insurance for Life Insurance

What special rules need to be considered for survivorship life insurance?

The IRS has approved the exchange of one survivorship life plan for another. It has not allowed an exchange of single life coverage—either on one of the insureds or policies on each of the insureds—for second-to-die. See PLR 9542037.

Advanced Underwriting Consultants
www.advancedunderwriting.com
(615) 224-1291

A survivorship policy where one of the insureds has died may be exchanged for a life policy that insures only the survivor. See PLR.9248013 and PLR.9330040.

Loans

If a life policy has an existing loan against it at the time of its exchange, and the new policy does not, the loan balance is treated as taxable "boot" at the time of the exchange. Boot is taxable on a gain-first basis.

Where a life policy with an outstanding loan is exchanged for another life policy subject to a loan at least as large as the original policy's loan, the exchange will apparently be treated as an entirely tax-free exchange. See PLR 8806058 and PLR 8604033.

Basis

The basic rule of Section 1035 exchanges is that the new contract gets carryover basis from the old. We used to be pretty sure that, for life insurance, basis was calculated by adding up all the premiums paid and subtracting tax-free policy withdrawals or distributed dividends.

However, in Revenue Ruling 2009-13, the IRS asserted that the basis of a life insurance policy must be *reduced* by the *cumulative cost of life insurance protection* (COI) during the ownership of the policy.

The IRS did not explain anywhere in Revenue Ruling 2009-13 how COI should be calculated – or if it had to be reduced in circumstances other than those illustrated in the Ruling. We will have to wait for more guidance to get a reliable answer.

Guideline and Seven-Pay Premium

When a life policy is exchanged for a life policy, the advisor must help the client consider the effects of guideline premium limits and modified endowment contract (MEC) rules.

For the purpose of federal guideline premium, money that comes from the cash value of an existing policy into a new one is treated just like any other premium deposit. For example, if the federal guideline premium limit for a new $1 million contract is $150,000, that's the limit on the amount that can be deposited into the new contract. If the old policy has more cash value in it than that, either some money must be returned to the policy owner, or the face amount of the new coverage must be increased.

On the other hand, for the purpose of the MEC-determining seven-pay premium, exchanged monies are treated differently. A Section 1035 exchange is treated as a material modification of an existing contract, rather than the plain purchase of a new one, for seven-pay purposes. Section 1035 money, by itself, cannot cause a new contract to become a MEC. However, the money exchanged will cause the seven-pay limit to be reduced—limiting the MEC-free premium that may be paid into the new policy.

If the old policy is a MEC, the new life contract will also be a MEC.

Annuity Partial Exchanges

A partial 1035 exchange is one where a client takes part of a nonqualified annuity account and transfers it to a new annuity policy.

The Tax Court ruled in *Conway v. Commissioner*, 111 T.C. 350 (1998) that a partial exchange of non-qualified deferred annuity can qualify for tax-free treatment. Although the IRS reluctantly agreed to

Advanced Underwriting Consultants
www.advancedunderwriting.com
(615) 224-1291

accept the Tax Court decision, it worried that taxpayers would use the decision to devise strategies to avoid normal annuity taxation.

In Revenue Procedure 2008-24, the IRS set forth a special rule with regard to partial exchanges of annuities. For 12 months after a partial exchange, a subsequent withdrawal from, or surrender of, either the surviving annuity contract or the new annuity contract should be treated as an integrated transaction. The two contracts will be viewed as a single contract to determine the tax treatment of a surrender or withdrawal.

Revenue Procedure 2008-24 deals *only* with partial exchanges of annuities. It doesn't shed any light on whether the partial exchange logic extends to life insurance.

Other Unanswered Questions

Two (or More) for One

The Service has concluded that the exchange of two life insurance policies for one annuity contract is a proper IRC Section 1035 exchange. In PLR 9708016, the Service agreed that the annuity could be initially issued with the money from one life policy, then increased in value with the proceeds of the other.

In practice, most insurance carriers have applied that two-for-one logic to life insurance. Where the insured owns multiple policies on his or her life, a typical life insurance company will accept funds from the existing policies into a single new policy on the insured's life, and administer the new policy as if all the money rolled in is Section 1035 money. Likewise, most carriers of existing policies will process and report a transaction as a Section 1035 exchange even where they know there are multiple contracts being consolidated into a new one.

One for Two

If trading two policies for one is allowed as a tax free exchange, is the exchange of one policy for two permitted?

We aren't sure. A one-for-two exchange is essentially the same as a partial exchange. As we discussed earlier in this article, the IRS has permitted partial exchanges for annuities, but has made no such special allowance for life insurance. It makes sense that the same rules (or lack thereof) would apply to one for two exchanges, meaning that it should be OK for an annuity-for-annuity exchange, but not for any other Section 1035 exchange.

Term Insurance

For a long time, one of the most intriguing questions about Section 1035 was whether it permitted the exchange of a term insurance policy for a life policy or annuity. The IRS has not directly weighed in on this issue.

What would the advantage of such an exchange be?

Say Dan purchased a ten year level term policy in 2000, and paid ten annual premiums of $1,000. Now he is interested in buying a nonqualified deferred annuity with a deposit of $50,000.

After three years, Dan takes a $5,000 distribution from the annuity—when its cash value is $55,000. Under normal rules, Dan would expect to pay income tax on the entire annuity distribution under gain-first taxation rules.

But what if Dan, at the time he purchased the annuity, engaged in a Section 1035 exchange of his term life policy into the annuity contract? If the exchange were allowed, Dan would argue that his basis for the annuity was the $50,000 initial deposit *plus* the $10,000 aggregate premiums for the term life policy. If Dan's basis were $60,000, then the $5,000 distribution from the annuity after the third year would be tax free.

Unfortunately, Revenue Ruling 2009-13 may now stand in the way of Dan's plan. Situation 3 in the Ruling says that basis for a term policy is equal only to the unearned premium—not the aggregate premiums paid. This would leave little if any basis. So while some may have been able to claim all of a term policy's premiums as basis in a Section 1035 exchange in the past, such exchanges may not yield nearly as much tax advantage now. Again, this result is uncertain since the extent of Revenue Ruling 2009-13's reach is not yet known

Exchange Into Existing Policy

Section 1035 is designed to deal with exchanges of insurance policies. Some taxpayers have tried to use the value from an existing insurance policy to deposit into another existing contract. Where both policies were annuity contracts, the IRS has said that such exchanges qualify under Section 1035. See Revenue Ruling 2002-75.

In Private Letter Ruling 8810010, the IRS ruled that a taxpayer *may not* exchange the value of a *life policy* into another existing life policy under Section 1035.

Indirect Exchanges

Section 1035 exchanges usually involve the legal assignment of the old contract to the carrier issuing the new policy. What if the insurance companies won't cooperate and the old carrier insists on sending the *money* from the old contract to the policy owner?

The IRS has said that if the *policy owner* handles the money as part of the process, it's *not* a Section 1035 exchange. In Revenue Ruling 2007-24, the IRS was presented with these facts:

- The taxpayer owned an annuity contract issued by an insurance company.
- The taxpayer wanted to exchange the old annuity for a new annuity contract with another carrier.
- The old contract's carrier refused to assign the annuity to the new company, sending the taxpayer a check for the surrender value instead.
- The taxpayer received the check, and endorsed it over to the new company in payment for the new annuity contract.

The IRS ruled that the transaction was not a Section 1035 exchange, and taxed the taxpayer as if the old contract was simply surrendered.

While the Revenue Ruling maintains that an indirect exchange does not qualify as a Section 1035, there is a Tax Court case that says it *does.* In *Greene v. Comm.*, 85 TC 1024 (1985) under facts similar to those in Revenue Ruling 2007-24, the court ruled that the exchange was valid under Section 1035. However, with the much more recent authority of the Revenue Ruling, relying on *Greene* would be risky.

Partial Exchanges for LTC

The Pension Protection Act of 2006 created a new kind of Section 1035 exchange, effective January 1, 2010. It is now possible to exchange a life or annuity contract for a tax-qualified long term care insurance (LTCi) policy on a tax-free basis. Since there are currently relatively few single premium LTCi policies available, a straightforward exchange opportunity may not be widely available.

Some carriers apparently recognize multiple partial Section 1035 exchanges of existing annuity contracts to an LTCi plan. That kind of partial exchange strategy appears to be the likeliest way for a taxpayer to take early advantage of the rules change. Other carriers may advocate using some kind of SPIA to pay for LTC premium—arguing that the SPIA payments are partial exchanges, and therefore tax free.

Proponents of a multiple partial Section 1035 exchanges of annuity for LTCi point to the legislative history of the Pension Protection Act to support the idea that the partial exchange transactions will be tax free.

It seems to us that the IRS may attack this conclusion on at least two fronts:

- While partial exchanges of annuities for annuities have been blessed, there has been no such express approval for a partial exchange of an annuity for LTCi.

- After the first year, the partial exchange will be from an annuity contract into an existing LTCi policy. That kind of exchange has only been recognized for Section 1035 purposes for annuity to annuity transactions in the past.

So, what's the right interpretation? We don't know. The final word on this issue will have to wait for further guidance from the Service or from the Tax Court.

CONCLUSION

Section 1035 provides a method for certain taxpayers to avoid recognizing an income tax result when they exchange one insurance policy for another. While on its face Section 1035 seems simple, in practice the professional must consider whether one or more complications exist.

There are a number of issues for which the rules may differ depending on the type of policy that is being exchanged. For example, a partial exchange of an annuity is expressly allowed, but it appears that a partial exchange of a life contract is not.

For those situations where the applicability of Section 1035 to the facts is not crystal clear, what should the advisor do? If the professional is involved in the transaction early enough, the advisor might check with the carriers involved to make sure that they will report the transaction for tax purposes in a way consistent with expectations. If the tax documents created are not consistent with Section 1035, the client may want to reconsider the proposed steps. In some cases, the professional may be able to reconfigure the transaction to a more desirable result—perhaps by picking a new insurance carrier.

Where the IRS has staked unfavorable tax ground—or no tax ground has been plowed—even favorable tax reporting may not be enough. The prudent advisor should always work with the client's tax professionals to make sure they understand the potential dangers of a risky exchange, so the downside can be properly evaluated and managed.

Complications aside, the Section 1035 exchange is still a great tax savings opportunity for our clients to trade an underperforming or unneeded insurance policy for another.

Advanced Underwriting Consultants
www.advancedunderwriting.com
(615) 224-1291

Please remember a 1035 exchange should only be considered when the exchange is in the best interest of the client. There are fees and charges associated with a life insurance and annuity contracts that may include Mortality and Expense Risk Charges, administrative fees, investment management fees, surrender charges, and charges for optional riders. All of these factors should be closely considered and compared for each 1035 exchange. A client will be exposed to new surrender charges as well as possible new suicide and contestable clauses for life insurance contracts among other additional charges.

Policy loans and withdrawals will reduce the cash value and face amount of the policy. Clients may need to fund higher premiums in later years to keep the policy from lapsing.

Life insurance products are issued by either AXA Equitable Life Insurance Company (AXA Equitable). New York, NY or by MONY Life Insurance Company of America,(MLOA) an Arizona Stock Corporation with its main administrative office in Jersey City, NJ 07310. MLOA is not licensed to conduct business in New York. Variable Products are co-distributed by affiliates AXA Advisors, LLC and AXA Distributors, LLC. Fixed Life products are co distributed by AXA Network, LLC and AXA Distributors. LLC.

"AXA'" is a brand name of AXA Equitable Financial Services, LLC and its family of companies, including AXA Equitable Life Insurance Company(NY,NY), MONY Life Insurance Company of America (AZ stock company, administrative office: Jersey City. NJ), AXA Advisors, LLC, and AXA Distributors, LLC. AXA S.A. is a French holding company for a group of international insurance and financial services companies, including AXA Equitable Financial Services, LLC. This brand name change does not change the legal name of any of the AXA Equitable Financial Services, LLC companies. The obligations of AXA Equitable Life Insurance Company and MONY Life Insurance Company of America are backed solely by their claims-paying ability.

Please be advised that this document is not intended as legal or tax advice. Accordingly, any tax information provided in this article is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. The tax information was written to support the promotion or marketing of the transactions) or matters) addressed, and you should seek advice based on your particular circumstances from an independent tax advisor. Neither AXA Equitable, MLOA, AXA Advisors, AXA Network or AXA Distributors provide legal or tax advice.

IU-105848A (8/15) (Exp. 8/17) Cat. #154772 (8/15)

Advanced Underwriting Consultants
www.advancedunderwriting.com
(615) 224-1291