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TAX-DEFERRED EXCHANGES OF LIFE INSURANCE UNDER SECTION 1035

A primary advantage of cash value life insurance is the ability to replace an existing policy in the future. There are many reasons for exchanging an existing contract, including an opportunity for enhanced performance, as well as more robust features and benefits that align better with the policyholder's needs.

Under Internal Revenue Code (IRC) Section 1035, a properly transacted exchange can result in deferred taxation of any accumulated gain until the policyholder surrenders (or otherwise disposes of) the newly acquired policy.

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REASONS TO CONSIDER A POLICY EXCHANGE

Exchanging an existing policy for a new policy can:

- Reduce premiums and/or increase death benefit coverage.
- Older policies may use an outdated mortality table. Newer products using the current tables may have reduced mortality costs.
- The insured may qualify for better rates due to health improvements (for example, if the insured is no longer a smoker)
- Replace a policy not performing as projected.
- Cover an insured for an extended duration to address concerns of outliving the existing policy coverage.
- Transition to a carrier with better ratings and financial stability.
- Facilitate a change in insurance needs (for example, the policyowner now desires a guaranteed death benefit).
- Allow the policyowner to obtain a policy with other desired features, such as long-term care benefits.

TAX-DEFERRED EXCHANGES UNDER SECTION 1035

IRC Section 1035 states:

- No gain or loss shall be recognized on the exchange of a contract of life insurance for a) another contract of life insurance, b) an endowment,[1] c) an annuity contract, or d) a qualified long-term care insurance contract.

GENERAL REQUIREMENTS

- The insured party in the new policy must be the same as the insured party in the previous contract (i.e., a single life policy must be exchanged for another single life policy, or a survivorship policy must be exchanged for another survivorship policy). In a private ruling, the IRS has also sanctioned 1035 treatment of the exchange of a joint and last survivor life insurance policy for a single life policy following the death of one of the insureds.[2]
- The owner of the policy must remain the same both before and after the exchange.

FACTORS TO CONSIDER

THE "BOOT" CONSIDERATION

In most circumstances, the replacement of a life insurance policy with a new life insurance policy will result in the policyholder owning a new contract with a basis equal to that of the original contract, and will defer recognition of any taxable gain. However, the IRS has described circumstances where the policyholder receives not only a new insurance policy, but some additional payment of cash or other property as a result of the exchange. The IRS refers to these additional amounts as "boot." If the policyholder receives boot in an otherwise tax-free exchange, gain will be recognized to the extent of the boot received.

EXCHANGES OF POLICIES WITH OUTSTANDING POLICY LOANS

Life insurance policies with outstanding policy loans require special care during the exchange process to avoid adverse tax consequences.[3] The policyholder has two options when exchanging a policy with an outstanding loan:

Pay off the loan before the exchange: The original policy may have sufficient cash value available for withdrawal or partial surrender that can be used to pay off an existing policy loan. However, when this approach is used in close proximity to a 1035 exchange, the IRS may regard the repayment of the loan and the 1035 exchange as one integrated transaction, deeming the amount of the loan that was paid off as boot. It is therefore advisable to either

[1] An endowment contract is a contract with an insurance company that depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during the insured's life.
[2] Private Letter Ruling 9248013
[3] Internal Revenue Code Sections1031(b) and (c); see also Rev. Rul. 2003-56, and Private Letter Rulings 9141025 and 8905004

use a source of funds outside of the policy cash values to repay the loan or wait a reasonable period of time before initiating a 1035 exchange.

Carry the loan over: Most insurance carriers will allow the policyholder to acquire a new policy subject to the same indebtedness as the original policy while preserving tax deferral under Section 1035.[4] If the policyholder allows sufficient time to pass, the loan can be repaid using a withdrawal of basis from the new policy. Although there is no specific guidance from the IRS as to how much time must elapse before the repayment of the loan using policy values will be seen as a separate transaction, some insurance carriers will treat withdrawals within the first policy year of a new policy issued with a loan as a taxable distribution.

ADDITIONAL CONSIDERATIONS

- The new policy will be subject to an initial contestability period.
- The new policy will typically be issued with a surrender charge period that may last 7–20 years.
- A replacement will create a new seven-year excessive premium test. Policies failing the test are subject to adverse tax consequences.
- To justify the replacement, the benefit achieved must outweigh the acquisition costs.
- To qualify for a replacement policy, the insured must undergo underwriting.

CONCLUSION

There are many valid reasons to consider replacing an existing cash value insurance policy. Section 1035 offers policyholders a way to do so while preserving basis and tax deferral of any gain. As these replacements may involve a number of financial and tax factors, it is important to consult an experienced life insurance professional who can provide the insight necessary to produce successful results.

[4] Private Letter Rulings 8806058 and 8816015

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