Non-Taxable § 1035 Exchange of Life Insurance Contracts

By Robert Adler

I. Introduction

Internal Revenue Code ("I.R.C.") § 1035 permits owners of life insurance and annuity contracts to exchange their contracts for similar or related types of contracts without the recognition of any unrealized gain which may have accrued in the contract surrendered in the exchange.[1]

There are a variety of circumstances in which the holder of a life insurance or annuity contract may wish to exchange the original policy for a different type of insurance product or a similar product having different premium costs or other features.

While such exchanges would ordinarily be taxable transactions with gain or loss measured by the difference between the fair market value of the new policy and the owner's basis in the old policy, exchanges that meet certain basic requirements are granted non-recognition treatment by I.R.C § 1035. I.R.C § 1035 does not provide a permanent income tax exclusion for gains on such exchanges, but merely a deferral—since the basis of the contract given up is carried over as the basis of the new contract received.

II. Tax-Free Exchanges

Non-recognition under I.R.C. § 1035 applies to an exchange of:

1. a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; or
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
3. an annuity contract for an annuity contract.[2]

The contracts involved must meet the basic definitions of life insurance contract, endowment contract and/or annuity contract, as set forth in I.R.C. § 1035(b).[3] In all cases, the policy received must relate to the same insured as the policy given up in the exchange (although the contract issuer may be different).[4]

III. Debt Release as Boot

If an exchange would come within I.R.C. § 1035 except that other property or money is also received "to boot," gain (in the policy given up) is recognized up to the value of the boot received.[5]

If a policy which is subject to an outstanding loan is exchanged in a transaction otherwise qualifying for non-recognition under I.R.C. § 1035, the balance of the loan at the time of the exchange is treated as boot to the extent that it exceeds the amount of any loan balance outstanding on the new policy received.[6] This rule is necessary to prevent abuse of the non-recognition provision in a disposition transaction intended to yield cash (which would otherwise be taxable as boot) by structuring the transaction as a non-taxable loan followed by a non-recognized exchange.

A. Illustrative Example

W owns a life insurance policy with a basis of $50,000 and a current value of $80,000. He takes out a $60,000 loan against the policy. The receipt of the loan proceeds is not income. The following week, W exchanges his policy, subject to the loan balance, for a new life insurance policy with a value of $20,000. The $60,000 loan balance on the old policy is treated as boot (as well as part of the amount realized on the disposition of the old policy). Thus, there is a realized gain of $30,000, all of which must be recognized because the boot amount exceeds the gain. The basis in the new policy is $20,000 ($50,000 carryover, reduced by the $60,000 of boot and increased by the $30,000 of recognized gain). If the outstanding loan on the policy given up were not treated as boot, W would have received $10,000 cash in excess of his basis (at the time of the loan) and a policy worth $20,000, having a carryover basis of $50,000, with no recognition of any gain at any point.

B. Planning Pointer

If a policy subject to an outstanding loan is exchanged for a new policy, and the new policy is issued with an identical outstanding loan amount, there is no boot.[7]

If the new issuing company will not issue a policy subject to indebtedness, another way of avoiding boot is to pay off the loan on the old policy prior to the I.R.C. § 1035 exchange and then, if necessary, borrow against the new policy.

IV. Multiple Policy Exchanges

Several private letter rulings have dealt with various factual situations in which exchanges involved not

a straight exchange of one life policy for another life policy, or one annuity for another, but rather combinations of contracts, or contracts plus additional cash invested. For example:

- Private Letter Ruling 9708016 approved an exchange of two separate life insurance contracts for one annuity contract.[8]
- Private Letter Ruling 9644016 approved an exchange of a single annuity contract for two new annuity contracts.[9]
- Private Letter Ruling 9820018 approved a transaction in which a new annuity contract was acquired by, in effect, "trading in" an existing life insurance policy (issued by another company) and paying the balance of the cost of the new annuity in cash.[10] The ruling held that the fact that a cash payment by the taxpayer was part of the exchange would not render I.R.C. § 1035 inapplicable. It also concluded that the issuance of the new annuity in two steps, as the two elements of payment were separately received, would not disqualify the transaction.
- Private Letter Ruling 200323012 approved an exchange of two annuity contracts for a single new annuity contract.[11]

V. Examples of Exchanges That Do Not Meet the Same Insured Requirement and Thus Do Not Qualify for § 1035 Treatment

In Private Letter Ruling 9542037, the Internal Revenue Service (the "IRS") concluded that exchanges involving policies insuring a single life for a policy insuring two lives do not qualify for non-recognition treatment under I.R.C. § 1035.[12] In the letter ruling, the IRS sets forth five examples, none of which qualify for I.R.C. § 1035 treatment:

1. Spouse A exchanges a policy insuring only his life for a policy which insures the lives of both Spouse A and Spouse B.
2. Spouse A 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.
3. 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 which insures the lives of both Spouse A and Spouse B.
4. A trust owns and exchanges a policy insuring the life of Spouse A for a policy which insures the lives of both Spouse A and Spouse B.
5. A trust owns and exchange 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.

VI. Policy Exchanges Involving Modified Endowment Contracts

A modified endowment contract (a "MEC") is defined as any life insurance contract entered into on or after June 21, 1988 that meets the life insurance requirements of I.R.C. § 7702, but which fails to meet a special seven-pay test or is received in exchange for a MEC.[13]

If a life insurance contract that is grandfathered from the seven-pay test because it was issued before June 21, 1988 is exchanged on or after June 21, 1988, the grandfathering is lost and the new policy must qualify under the seven-pay test to avoid qualifying as a MEC.[14] If a MEC is exchanged for another policy, the new policy is also a MEC (even if it would not otherwise qualify).[15]

VII. Commonly Overlooked Planning Opportunity to Preserve Basis

A. Facts

Seventeen years ago, Client purchased a universal life insurance contract, paying premiums of $5,000 per year. This policy offered no cash value for the first 20 policy years. As such, it was essentially equivalent to a level premium, annually renewable term insurance contract (and was probably sold on that basis), but the contract was filed with regulatory authorities as a universal life product. (This type of universal life contract, sometimes referred to as "term look-alike," was commonly offered when Client purchased his policy.)

Seventeen years have now passed, and Client is about to replace this policy with a new product recommended by his insurance adviser, Joe. Joe prepares an application for the new policy, and Client signs it and submits the initial premium. The new policy is issued and the old policy is simply allowed to lapse. Should anything more have been done?

Like other assets, life insurance contracts have a tax basis in the hands of the policy owner. It is commonly accepted that the basis of an insurance contract includes all of the premiums paid in, and that this "cost" basis is used as the recoverable investment in the contract for purposes of computing any gain on the taxable disposition of a policy and determining the portion of cash value withdrawals which represent tax-free cost recovery. In general, this measure of basis is applicable without regard to the policy's cash value at any given time. (Thus, after seventeen years of annual $5,000 payments, Client's tax basis in his surrendered policy was $85,000.)

As is the case with other forms of tax-deferred exchange transactions, when a life insurance contract is exchanged for another life insurance contract in a tax-deferred exchange transaction under I.R.C. § 1035, the basis in the newly acquired policy is equal to the basis in the old policy at the time of the exchange, plus any premiums paid with respect to the new policy.

This carryover basis rule is a fundamental aspect of sales, exchanges or other dispositions of property in which no gain is recognized for tax purposes. It is through the carryover of a below market value basis that any unrealized gain at the time of the exchange is effectively deferred for potential taxation later, when the asset is disposed of in a taxable transaction. However, the carryover of basis can operate to the taxpayer's advantage in situations where the holder of a life insurance policy intends to replace it with a new policy—even in instances where surrender of the old policy would not result in any taxable gain.

B. What Client Could Have Done

In the scenario described above, no thought was given to exchanging the old policy for the new one. Section 1035 exchanges of insurance policies are typically employed in situations where the policy given up has a cash value great enough that a taxable gain would be realized upon its surrender. In Client's case the cash value was zero, even though there was an $85,000 basis in the surrendered contract.

However, by surrendering or lapsing Client's original universal life, term look-a-like policy, his $85,000 of basis is forever lost. What if Joe were to have taken an extra step and structured the sale of the new policy as an exchange for the old universal life policy? This would seem to involve no more than a bit of additional paperwork, but could have provided Client with a potentially valuable tax benefit down the road—an $85,000 increase in the basis in the new policy from day one. The practical effect is that Client could have enjoyed $85,000 more in tax-free withdrawals from the new contract in future years.

This potential preservation of basis by simply completing additional paperwork to effect an I.R.C. § 1035 exchange is sometimes overlooked when replacing low cash value universal life policies or universal life, term look-alike contracts having no cash value. Since it has long been accepted that a life insurance contract has a tax basis equal to the aggregate premiums paid—without regard to the level of the cash value at any particular time—a policyholder who simply terminates his or her old policy at the time of replacement with a new one is wasting an opportunity to transfer that basis to the new policy, with potentially substantial benefits down the road.

C. Conclusion

The point made in the immediately preceding paragraphs—that preservation of basis through an I.R.C. § 1035 exchange can provide a substantial future tax benefit for clients—is the central message of the example provided. It is important to note that the focus is on exchanges of universal life contracts for universal life contracts (or other life insurance contracts *other than term life insurance*). This includes even term look-alike contracts that may be viewed by insureds as term insurance but are actually universal life contracts with no current cash value.

Endnotes

1. 26 U.S.C. § 1035(a).
2. *Id.*
3. 26 U.S.C. § 1035(b).
4. 26 C.F.R. § 1.1035-1.
5. 26 U.S.C. § 1031(b).
6. *See* 26 C.F.R. § 1.1031(b)-1(c).
7. *See* Priv. Ltr. Rul. 8604033 (Oct. 25, 1985); Priv. Ltr. Rul. 8816015 (Jan. 11, 1988).
8. Priv. Ltr. Rul. 9708016 (Nov. 20, 1996).
9. Priv. Ltr. Rul. 9644016 (July 18, 1996).
10. Priv. Ltr. Rul. 9820018 (Feb. 11, 1998).
11. Priv. Ltr. Rul. 200323012 (Feb. 20, 2003).
12. Priv. Ltr. Rul. 9542037 (July 21, 1995).
13. 26 U.S.C. § 7702A(a). A contract fails to meet the seven-pay test when the amount paid under the contract at any time during its first seven years is greater than "the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums." 26 U.S.C. § 7702A(b).
14. *See* Priv. Ltr. Rul. 9044022 (July 31, 1990).
15. 26 U.S.C. § 7702A(a)(2).

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A version of this article appeared online in onlineAUS.com.