John Hancock INSURANCE

ADVANCED MARKETS

BECAUSE YOU ASKED

§1035 Tax-Free Exchanges of Life Insurance

There are many reasons why an owner of an existing insurance policy may want to replace that policy for a new policy. A §1035 exchange, when structured correctly, can be an effective way to replace such a policy without having to recognize taxable gain. This piece is intended to provide an overview of the rules surrounding §1035 exchanges.

Table of Contents

LIFE-7648 6/17

1. What is a §1035 exchange?

Sections 1031 through 1045 of the Internal Revenue Code provide for the tax-deferred exchange of like-kind properties. Section 1035 sets out provisions dealing with exchanges of life insurance, endowment contracts, annuities, and long-term care policies. Under Section 1035, taxation of gain is deferred for individuals who "merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain."[1]

The owner of the property acquired in a §1035 exchange takes that newly acquired property with the same basis as the property given up in the exchange.[2] This basis carry-over postpones gain recognition until the taxpayer disposes of the newly acquired property.

2. What are the requirements for a §1035 exchange?

Generally speaking, no gain or loss will be recognized on the exchange of:

- **A life insurance contract for:**
  - another life insurance contract;
  - an endowment contract;
  - an annuity contract; or
  - a qualified long-term care insurance contract
- **An endowment contract for:**
  - another endowment contract which provides for regular payments starting no later than the date the payments would have begun under the contract exchanged;
  - an annuity contract; or
  - a qualified long-term care insurance contract
- **An annuity contract for:**
  - another annuity; or
  - a qualified long-term care insurance contract
- **A qualified long-term care contract for another qualified long-term care contract**

Note that §1035 establishes a hierarchy, whereby a life policy can be exchanged for any other insurance product mentioned (e.g., annuity, endowment, long-term care), but the reverse is not true. Moreover, due to legislation passed in 2009, adding a long-term care rider to an annuity or life insurance policy does not disqualify the exchange as a like-kind transfer. In addition, while the code allows a life insurance policy to be exchanged for a stand-alone long-term care policy, many carriers cannot administer this type of exchange.

The following additional requirements must also be met to qualify for §1035 exchange treatment:

- there must be the same owner both before and after the exchange; and
- both policies must relate to the same insured[3]

3. What if the policy being exchanged is a Modified Endowment Contract?

A Modified Endowment Contract ("MEC") is defined in §7702A(a)(1) as a life insurance contract that is both entered into after June 21, 1988 and fails to meet the 7-pay test of §7702A(b).[4] Generally speaking, if an existing MEC contract is exchanged under §1035, the new contract will retain the MEC status and will also be a MEC. This gives rise to the rule "once a MEC, always a MEC."

4. Is the new policy received in a §1035 exchange subject to testing under the Modified Endowment Contract rules?

Yes. Section 7702A(c)(1) requires that all contracts be tested for compliance with the MEC rules at the time of their issue. This means that if a contract issued as part of a §1035 exchange fails the 7-pay test it will be considered a MEC.

MECs & Taxation

MEC policies differ from traditional life insurance policies with regard to taxation. Generally speaking, distributions from a MEC contract will be taxed on a last-in first-out (LIFO) method (i.e. gain will be distributed first and be taxed as ordinary income) and may include a 10% penalty when distributions occur before age 59 1/2. For these reasons, most policies are designed to avoid status as a MEC.

5. Is it possible for a contract issued under §1035 to constitute a MEC when the original contract was not a MEC?

Yes. For example, if there is a reduction in the face value of the newly issued contract in relation to the original contract, the new contract may fail the 7-pay test. A policy may also qualify as a MEC if there is a contribution of outside funds at the time of the §1035 exchange in addition to the cash value being carried over from the original contract. This additional contribution may be enough to cause the newly issued contract to fail the 7-pay test of §7702A.

6. Is it possible to §1035 exchange two single life policies for a survivorship policy.

No. The IRS held in Private Letter Ruling (PLR) 9542037 that the exchange of a single life policy into a survivorship policy violates the "same insured" requirement for a valid §1035 exchange under IRS Reg §1.1035 (see Question 2).

In PLR 9542037, the IRS examined several different situations including:

- The exchange of a policy on the life of Spouse A for a policy on the joint lives of Spouses A and B;
- Spouse A exchanges two single life policies, one on Spouse A and the other on Spouse B, into one survivorship policy insuring Spouses A and B;
- Spouses A and B jointly exchange single life policies on each of their lives for a jointly owned survivorship contract insuring both Spouses; and
- Situations similar to situations 1 and 2 above, except that the policies are owned by trusts

In all of the above situations, the IRS held that the exchanges would not qualify for tax deferral under §1035 because the policies did not relate to the same insured. .

7. Is it possible to exchange a survivorship policy for a single life policy under §1035?

Possibly. PLRs 9248013 and 9330040 both involved a proposed exchange of a survivorship insurance contract, with only one of the insured still living, for a new single life insurance contract. In both PLRs, the IRS held that because there was only one remaining insured on the original contract, the exchange of that contract for a single life contract would qualify for tax-deferral, because both policies related to the same insured, making them like-kind policies.

However, both PLR 9248013 and PLR 9330040 state that they make no determination as to the possibility of exchanging a survivorship insurance contract for single life contracts if both insureds under the original contract are still living. As discussed above, PLR 9542037 makes it clear that an exchange of two single life contracts to one survivorship contract does not qualify for tax-deferral under §1035. There is no indication that unwinding a survivorship contract into two single life contracts should get any different tax treatment. Keep in mind that a PLR is binding authority only on the taxpayer to whom it is issued.

8. Are there potential tax implications associated with a withdrawal of cash value immediately before or after a §1035 exchange?

Yes. Under IRC §72, an owner of a non-MEC insurance contract may withdraw policy cash values up to the basis in the contract without recognizing gain (i.e., FIFO treatment- "first in, first out"). This allows the policy owner to recover his or her basis in the life insurance contract while leaving the gain inside the policy. However, §1035 exchanges are permissible under, and controlled by, §1031, not §72. Under §1031(b), if an owner exchanges like-kind property and also receives "other money or property" (e.g., the monies received in the withdrawal) in addition to the like-kind property, that additional property is considered to be "boot". The receipt of "boot" in a 1035 exchange is included in the policy owner's taxable income to the extent of gain in the original insurance contract. Accordingly, the withdrawal of cash value immediately before or after exchange is considered to be a boot transaction, to the extent there is gain in the contract, and the transaction will be taxed on a "last in, first out" basis (LIFO).

Note that in PLR 8905004, the IRS held that the withdrawal rules of §72 cannot be used to circumvent the boot recognition rules of §1031(b). This same ruling also applied the step-transaction doctrine to a withdrawal and subsequent §1035 exchange of an annuity contract, requiring the policy owner to recognize income ("boot") to the extent of gain in the contract. While the IRS has applied the step-transaction doctrine to withdrawals on both sides of a §1035 exchange, there is no indication from the IRS as to how much time has to elapse between the withdrawal and the exchange in order to avoid the step-transaction doctrine.

EXAMPLE 1:

Gain in Contract: *The following is an example of the application of §1031(b) to a withdrawal immediately before a §1035 exchange where there is a gain in the contract. Assume that prior to the exchange there was $1,000 of gross cash value, a basis of $500, and the taxpayer plans to withdraw $400.*

GAIN CALCULATION

Cash Value transferred to new policy		$600
Cash withdrawn prior to Exchange ("boot")	+	$400
Total consideration received in exchange		$1,000
Basis in original policy (premiums paid)*	-	$500
Gain Realized (Total consideration less basis)		$500
1031(b) Gain Recognized		**$400**

Reminder: 1031(b) gain = lesser of boot and gain in the contract

* Under the §1031(d) basis rules, basis in the new contract is decreased by the amount of boot received and increased by the amount of gain recognized (so in the above example, old basis ($500) less boot received ($400) plus gain recognized ($400) = $500 new basis). (See Question 12 for more information on basis adjustment.)

EXAMPLE 2:

No Gain in Contract: *The following is an example of the application of §1035(b) to a withdrawal immediately before a §1035 exchange where there is no gain in the contract. Same facts as Example 1, except now basis is $1,100.*

GAIN CALCULATION

Cash Value transferred to new policy		$600
Cash withdrawn prior to Exchange ("boot")	+	$400
Total consideration received in exchange		$1,000
Basis in original policy (premiums paid)	-	$1,100
Gain Realized (Total consideration less basis)		$0
1031(b) Gain Recognized		**$0**

Despite receipt of $400 of "boot," no 1031(b) income is recognized as there isn't any gain in the contract

9. What if a loan on the policy is carried over to the new contract in a §1035 exchange?

If all of the cash value in the existing policy and the entire existing loan is carried over from the old policy to the new policy, then there is no receipt of "boot" (i.e. "other property or money") for purposes of §1031(b) and therefore no gain must be recognized in the exchange. See PLR 8806058.

10. What if the policy cash values are used to extinguish the existing loan as part of the §1035 exchange?

Using policy cash values to extinguish a loan as a part of the §1035 should trigger income to the policy owner, to the extent of gain in the contract, because the repayment of the loan using internal cash value (or paid-up additions) is considered to be the receipt of "other property or money" for the purposes of §1031(b) and the boot-recognition rules.

As indicated in PLR 9141025, the use of policy cash values to extinguish the loan is considered a partial surrender of the policy's cash values or a withdrawal of those values immediately prior to the §1035 exchange. The IRS then applies the step-transaction doctrine to the surrender/withdrawal and the exchange, treating the amounts used to repay the loan as boot to the policy owner, which triggers income to the extent of gain in the contract.

EXAMPLE

Loan Extinguished With Cash Value: *Assume that prior to the exchange there was $1,000 of gross cash value, a $400 loan on the contract, a basis of $600, and the taxpayer plans to extinguish the loan prior to or in conjunction with the §1035 exchange.*

GAIN CALCULATION

Cash Value transferred to new policy		$600
Cash Value used to extinguish loan ("boot")	+	$400
Total consideration received in exchange		$1,000
Basis in original policy (premiums paid)	-	$600
Loan on new policy	-	$0
1031(b) Gain Recognized		**$400**

11. What if the policy owner uses outside (non-policy) funds to extinguish the loan as part of a §1035 exchange?

A use of outside (non-policy) funds will not trigger the boot recognition rules of §1031(b) because using outside funds is not considered the receipt of "other property or money" in conjunction with the §1035 exchange. In this case, the taxpayer has not accessed any of the policy's cash values to repay the policy loan; rather, the policy owner actually came out of pocket to repay the outstanding liability rather than relying on policy values.

12. How is the basis in the newly issued contract under a §1035 exchange calculated?

Exchanges of policies under §1035 are designed to defer the tax in the original contract, which means that the basis in the original contract has to be preserved and carried over to the newly issued contract. Section 1031(d) provides that the basis in the newly exchanged property is the same as the basis in the original property (i.e., "carry-over basis") except that the basis is (1) decreased by the amount of "boot" received in the transaction and (2) increased by the amount of gain recognized in the exchange.

EXAMPLE

The following is an example of the application §1031(d) adjusting the basis in a newly issued contract following the withdrawal of cash value and a subsequent §1035 exchange. Assume that prior to the exchange there was $1,000 of gross cash value, no loan, a basis of $700, and the taxpayer plans to withdraw $400 prior to the exchange.

GAIN CALCULATION

Cash Value transferred to new policy		$600
Cash Value used to extinguish loan ("boot")	+	$400
Total consideration received in exchange		$1,000
Basis in original policy (premiums paid)*	-	$600
Loan on new policy	-	$0
1031(b) Gain Recognized		**$400**

BASIS CALCULATION

Basis of old policy		$700
Boot received	-	$400
Amount of 1031(b) Gain Recognized	+	$300
Basis of new policy		**$600**

1. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).
2. IRC §1031(d).
3. See Treas. Reg. §1.1035-1; Rev. Rul. 90-109.
4. See IRC §7702A(a)(1).