The Wealth Counselor
A monthly newsletter for wealth planning professionals

Section 1035 - Tax-Free Exchange of Life Insurance Policies

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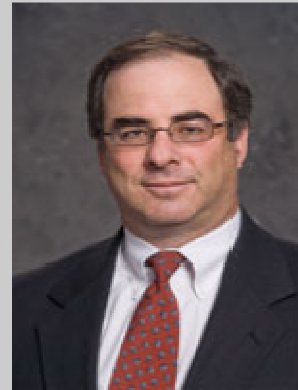

EDWARD S. MARIN, ESQ., C.P.A., LLM-Tax practices in the areas of Trusts and Estates, Estate and Gift Tax Planning, Probate, Trust Administration, Business Succession Planning, Income Tax Planning and Charitable Planning.

This issue of The Wealth Counselor examines a topic that should interest all owners of non-term life insurance policies and their advisors - Internal Revenue Code Section 1035 and its application. A 1035 exchange of life insurance policies, unlike a surrender or sale of a policy, is not an income recognition event. This can allow the policy owner, for example, to take advantage of lower insurance costs due to increased life expectancy, obtain new life insurance features and benefits, or replace a policy that is not performing at an acceptable level and do so without having to pay income taxes on the transaction.

With today's new mortality tables, clients in good health can often exchange an existing policy for a new policy that offers both lower premiums and more death benefit, even though the insured is significantly older than when the original policy was issued. An understanding of how 1035 exchanges work allows wealth planning professionals to increase sales, reduce fiduciary exposure, provide better service to clients, and strengthen their position as the clients' trusted advisor.

What is a 1035 Exchange?
Internal Revenue Code Section 1035 permits the owner to exchange one life insurance contract for another on a tax-free basis. It requires that neither the policy owner nor the insured life or lives be different after the exchange. In a 1035 exchange, the owner's cost basis in the old policy carries over to the new policy.

What does not have to be the same before and after includes the death benefit, premiums, or policy structure. Thus, for example, Section 1035 permits the exchange of a variable

policy for a whole life policy or a $500,000 policy for an $800,000 policy. In addition, Section 1035 permits the exchange of multiple policies on one life for one policy on the same life.

Planning Tip: Section 1035 DOES NOT permit the exchange of two single life policies on different insureds for a survivorship life policy on the two insureds or vice versa. However, the exchange of a survivorship life policy for another survivorship life policy on the same insureds should qualify as a tax-free exchange.

Planning Tip: After one of the insureds dies, a joint-life policy becomes a single-life policy and can be exchanged for another single-life policy on the survivor.

Planning Tip: Under Code Section 1031(b), gain from a life insurance policy exchange that is not solely "like-kind" may create income tax liability.

Planning Tip: If the existing policy is a Modified Endowment Contract (MEC) (which means that the owner cannot access cash value without incurring income tax liability), an exchanged policy is automatically a MEC.

Why Should Clients Consider 1035 Exchanges?
There are many reasons why clients and their advisors should consider 1035 exchanges. Probably the most common is because in today's market it is often possible to reduce premiums and/or increase coverage through a 1035 exchange. There are two principal reasons why this is so.

First, policies written even just a few years ago may use an outdated mortality table. Using the current (2000) tables instead of their predecessor (the 1980 tables) results in dramatic mortality cost reductions because Americans are living longer. Reductions compared to earlier mortality tables are even larger.

Secondly, the built-in administrative cost burden of newer life insurance policies is lower. The cash value of permanent life insurance is affected by the internal costs and administrative fees that are built into the policy. Therefore, a newer policy with lower costs and fees will accumulate cash value faster than an older policy with higher built-in costs and fees.

Often, even though the insured is now older, the reduced mortality costs and built-in fee burdens on a policy mean that premiums can be dramatically lower for the same coverage. This offers myriad possibilities through combinations of reducing premium costs and increasing the death benefit.

Another reason to consider a 1035 exchange is if the policy is not performing as originally projected. Many policies issued five or more years ago are in that category in part because the internal interest rate assumptions are higher than current historically low interest rates. In other words, if a policy issued in the early 1990s assumed a 9% return

but is only earning 4%, the policy will require more premium payments than originally projected to make up for that shortfall - and those additional premiums may be required over many additional years. A 1035 exchange allows the insured to exchange into a policy that has assumptions based upon current, low rates of return - providing a greater degree of certainty as to future premium payments needed to keep the policy in force.

A final reason is older clients may live longer than their existing policy was written to cover. Older policies typically endow at age 100, whereas newer policies extend the endowment age to 120 or beyond.

Exchanges of Policies with Loans
If the policy has an outstanding loan the owner must either: (1) carry the loan over to the new policy; or (2) pay off the loan prior to the 1035 exchange. Most insurance companies will not carry an existing loan over to a new policy.

If a policy has an outstanding loan at the time of a 1035 exchange that is not paid off or carried over to the new policy, the IRS will treat the loan as "boot," taxable as ordinary income to the extent of the gain. Boot is a "deemed distribution" to the policy owner and is generally any value from the old policy that is not transferred to the new policy. The deemed distribution (boot) is the lesser of the partial surrender made to extinguish the loan or the built-in gain in the policy.

Planning Tip: If the owner does not want to pay off a policy loan, consider a partial surrender (policy death benefit reduction) to extinguish the loan. This reduces the policy's death benefit and gross cash value, but not its net cash value.

For example, assume a policy with a gross cash value of $130,000, a $100,000 loan, and a cost basis of $75,000. A partial surrender to eliminate the loan amount will cause a deemed distribution of $100,000, reducing the gross cash value to $30,000. Since $25,000 of the deemed distribution is in excess of the cost basis, the owner will recognize $25,000 of ordinary income and will have a zero cost basis for the policy after the partial surrender. Net cash value will remain at $30,000.

Planning Tip: The key to receiving favorable income tax treatment when doing both a partial surrender to extinguish a policy loan and a 1035 exchange of the same policy is to have the IRS treat the partial surrender and the 1035 exchange as separate transactions. Then, Code Section 72(e) will govern and the policy owner can recover his entire cost basis before being subject to tax on any gain.

If the partial surrender occurs "shortly before or shortly after" (not defined by the IRS) the 1035 exchange, IRS will treat them both as one transaction. A single transaction will be subject to tax under Code Section 1031 and the policy owner cannot recover his cost basis first.

Planning Tip: Wait for several months (up to 12 or until another policy year, if possible)

after the partial surrender to implement the 1035 exchange. That will maximize the probability of having the partial surrender and the 1035 exchange treated as separate transactions. Ask the insurance company whether it will issue a 1099 and for how much if the 1035 exchange takes place at the target time. If the answer indicates the insurance company intends to report the two transactions as one, find out when it would not do so.

There are alternatives a policy owner may be able to use to pay off a policy loan. One is to use personal funds (including dividends from the existing policy). In this case there would be no deemed distribution because the owner would simply be returning the cash previously borrowed from the policy. The owner can also use funds obtained via a loan on a different policy or asset to pay the loan down to or below the policy's cost basis.

Planning Tip: A policy owner has two options to avoid recognition of income when doing a 1035 exchange with a policy that has a loan against its cash value that cannot be carried over to the new policy:

1. Use funds from another source, including borrowing against another policy, to pay off the loan; or
2. Make a partial surrender of the policy to eliminate the loan and postpone the 1035 exchange for several months.

Planning Tip: Examine all of the client's life insurance policies to determine the best 1035 exchange strategy. For example, it may be possible to borrow against policies with loans that are less than their policy cost bases to bring another policy loan down to that policy's cost basis.

Planning Tip: It is usually not advantageous to do a 1035 exchange in the month before a policy's anniversary because of how the policy dividend date is defined and because of the reduction in surrender charges that typically attend a policy passing its anniversary.

Conclusion

Tax-free exchanges of life insurance policies under Code Section 1035 provide an opportunity to "trade in" a life insurance policy on a "new model" without having to recognize taxable income. By working together, the planning team can identify those clients who might benefit from a 1035 exchange and explore all options to meet each client's unique planning goals and objectives. Failure to take advantage of the 1035 exchange opportunities that exist in today's market could expose fiduciaries to beneficiary claims.

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to your clients. Please feel free to contact me if you have any questions about this or any matters relating to estate or wealth planning.

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