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# Section 1035 Exchanges

**FOR MORE INFORMATION**

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For a variety of reasons, the owner of an insurance policy may wish to replace such policy for another insurance policy. Life insurance, endowment contracts, and deferred annuities are tax-deferred vehicles, and; subsequently, many of the policies being replaced will have taxable "gain." A properly structured Section 1035 exchange may avoid tax recognition at the time of the exchange. The rules, however, may get complicated.

## Types of insurance qualifying for 1035 exchange treatment

Under IRC Section 1035:

- Life insurance policy may be exchanged for another life policy, an endowment policy, an annuity or a qualified long-term care policy.
- Endowment policy may be exchanged for another endowment policy (with a maturity date no later than the endowment policy being replaced), an annuity or a qualified long-term care policy.
- Annuity may be exchanged for another annuity or a qualified long-term care policy.
- Qualified long-term care policy may be exchanged only for another qualified long-term care policy.

Note that an exchange into a life insurance policy is only possible if the policy being exchanged is a life policy. Life policies would include virtually all universal life policies and whole life policies. Certain policies designed to mature during the life of the insured may be considered endowment policies. Endowment policies are generally policies issued by insurance carriers many years ago. Few, if any, insurance carriers issue such policies today. An endowment policy may not be exchanged for a life contract.

A modified endowment contract (MEC) is generally a life policy with less favorable tax attributes during the life of the insured than a normal life policy. An exchange of a MEC for another life contract will cause the new life policy to also be classified as a MEC. A MEC may also be exchanged for an annuity or qualified long-term care policy.

## 1035 exchange requirements

The owner and insured/annuitant on the old and new contracts must be the same. The IRS is fairly strict on the "same insured" requirement. For example, the IRS ruled in Private Letter Ruling 9542087 that exchanging a single life policy on each spouse for one survivorship life policy on both spouses will not meet the "same insured" requirement. However, a 1035 exchange from a survivorship life policy to a single life policy is permitted under Private Letter Ruling 9330040, if one of the insureds on the survivorship life policy has died prior to the policy exchange.

The IRS has been flexible regarding the number of policies being exchanged. For example, the IRS has permitted the exchange of two life contracts for one new annuity contract. They have also permitted the exchange of one annuity contract for two annuity contracts. Other combinations may also be acceptable to the IRS based on IRS rulings or reasonable inferences of IRS rulings.

The IRS also permits a partial 1035 exchange of an annuity for another annuity if certain conditions are met, as discussed in Revenue Ruling 2003-76. This ruling does not cover the partial exchange of a life policy. Thus, a partial 1035 exchange of a life policy may not be acceptable to the IRS.

There are a number of procedural requirements which must be followed to qualify a replacement as a 1035 exchange. These procedures differ from IRA rollover procedures. The insurance agent and carriers involved in the exchange should be able to assist with these procedures.

## Taxable boot

A 1035 exchange in which the policyowner receives cash or other property, in addition to a new insurance contract, may not be tax free. Under Section 1031(d), the cash or property received (often called “boot”) will be considered taxable income to the extent of the lesser of the cash or property received or the entire gain in the policy being replaced.

The issue of boot often comes up when a life policy with a policy loan is exchanged for an insurance product (life, annuity, or qualified long-term care), with the policy loan extinguished at the time of the exchange. In such case, the loan extinguishment will be considered “boot” and taxable on a “gain out first” basis.

Several private letter rulings permit a policy loan to be carried from one life policy to another as part of a 1035 exchange. In such case, the IRS ruled there was no loan extinguishment and, thus, no taxable boot.

A distribution from a life policy (normally taxed on a “cost out first” basis) may be taxed on a “gain out first” basis as boot if a 1035 exchange closely follows the distribution. Under Private Letter Ruling 9141025, the IRS applied the step doctrine to collapse a partial withdrawal to repay a policy loan prior to a 1035 exchange into the 1035 exchange itself causing the partial withdrawal to be taxed on a “gain out first” basis as “boot.”

## Policy cost basis

A successful 1035 exchange would cause the cost basis of the policy being replaced to be carried over to the new insurance policy. Any taxable income recognized as boot would increase the cost basis of the new policy.

In the case of a partial exchange from an annuity to another annuity, the cost basis would be allocated ratably between the two contracts based on the percentage of cash value retained in the initial annuity and percentage of the cash value transferred to the new annuity.

## Summary

Section 1035 exchanges may help avoid a taxable event occurring upon the termination of certain insurance products, including life insurance and deferred annuities. There are, however, a number of rules which must be followed if such exchanges are to be tax free.

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