§ 1035 exchanges

In brief

A § 1035 exchange is a surrender of part or all of one or more contracts in exchange for the purchase of one or more contracts, where no income tax is triggered on the gain of the surrendered contract pursuant to § 1035 of the Internal Revenue Code.

Tax benefits

- Avoids triggering income tax on gain in the surrendered policy, provided there is no loan on the policy (see below).
- A large lump sum paid into a new life policy can often cause it to be a modified endowment contract (MEC), but a lump sum going into a new policy via a § 1035 exchange will not cause it to be a MEC. However, some other factor could trigger MEC status, such as a reduction of death benefit or additional large premium payments into the new policy.
- The new policy will start off with the same tax basis as the old policy. This is particularly important when the tax basis of the old policy is higher than the net cash value. Without a § 1035 exchange, the new policy will lose this higher basis and instead have a basis equal to the premiums paid on the new policy, potentially resulting in more income tax later if withdrawals are taken from the new policy or it is surrendered.

Other tax rules

- After the exchange, a new 15-year period starts for forced-out gain purposes under Section 7702(f)(7). Forced-out gain is taxable income that could result if cash is withdrawn from the life policy and the death benefit is reduced within the first 15 policy years.
- The cash from the old contract must transfer directly to the new contract without passing through the hands of the policyowner.

ALLOWABLE EXCHANGES

FROM \ TO	Life insurance	Annuity	LTC
Life insurance	Yes	Yes	Yes
Annuity	No	Yes	Yes
LTC	No	No	Yes

NOTE: Under § 1035, a Life/LTC combination product is treated as a life insurance contract, and an Annuity/LTC combination product is treated as an annuity contract.

From life insurance generally

- When exchanging from a life insurance policy to another life policy, the new policy must have the same insured as the old policy.
  - Similarly, if exchanging from a life policy to an annuity, the annuitant on the new annuity contract should be the same as the insured on the old life insurance policy.
  - Northwestern Mutual also recommends that the owner remain the same on both the surrendered and the new contract (but the owner does not have to be the same person as the insured/annuitant).
- A single life policy cannot be exchanged for a joint life policy.
- A joint life policy cannot be exchanged for a single life policy (unless one of the insured individuals is deceased, in which case the joint policy can be exchanged for a policy insuring the survivor).
- If a MEC is exchanged for another life insurance policy, the new contract will also be a MEC.
- A life insurance policy can be partially exchanged into a long-term care (LTC) policy.

From life insurance with a loan

- A § 1035 exchange of a policy with a loan will trigger income tax on the gain in the contract if the loan is extinguished as part of the exchange, which will be the case for an incoming exchange to Northwestern Mutual.

- The taxable amount is the lesser of gain in the policy or the amount of the loan. Gain is equal to gross cash value minus the investment in the contract (which is generally the tax basis).

  Example 1
  Dad has a life insurance policy that he'd like to exchange. It has a loan of $50,000, gross cash value of $90,000, and a tax basis of $75,000. Gross cash value of $90,000 minus the tax basis of $75,000 equals a $15,000 gain. The loan is $50,000. The lesser of those two is $15,000, meaning that the taxable amount is $15,000.

  Example 2
  Dad has a life insurance policy that he'd like to exchange. It has a loan of $50,000, gross cash value of $90,000, and a tax basis of $105,000. Gross cash value of $90,000 minus the tax basis of $105,000 equals a $15,000 loss. Whatever else is concluded about the loss, there is clearly no gain. So the gain in the contract is $0 and the loan is $50,000. The lesser of those two is $0, meaning that the taxable amount is $0.

- To avoid paying income tax due to the extinguishment of the loan during the § 1035 exchange, the policyowner can pay back (eliminate) the loan before the exchange.

  This can be done several ways, including:

  – using funds from outside the policy, or

  – withdrawing cash or surrendering additions from the policy to pay back the loan. If this latter method is used, a reasonable amount of time should elapse between the withdrawal and the exchange to avoid an IRS challenge under the step transaction doctrine. The withdrawal will generally trigger income tax to the extent the withdrawn amount exceeds the basis.

From an annuity generally

- When exchanging from an annuity contract to another annuity contract, the new contract must have the same obligee as the old contract. Although "obligee" likely refers to the owner, it might also refer to the annuitant. To avoid uncertainty, Northwestern Mutual generally requires that both the owner and annuitant remain the same in the new contract as they were in the old contract (but the owner does not have to be the same as the annuitant).

- The law does not preclude an exchange from an annuitized contract, but few companies allow it, given that it presents a practical difficulty in that there is no lump sum with which to purchase the new contract.

- The transfer of annuity contract surrender proceeds into an existing annuity contract qualifies as a § 1035 exchange. Rev. Rul. 2002-75.

- After death of the annuity owner, a beneficiary can do a 1035 exchange. Priv. Ltr. Rul. 2013-30-016.

Partial exchange from an annuity

- Partial exchanges from one annuity to another annuity are allowed in certain circumstances, such as if no withdrawal is taken from either contract within 180 days, or part of either contract is annuitized over a period of at least 10 years. Rev. Proc. 2011-38.

- The basis of the original annuity contract is prorated between the two new contracts. Rev. Rul. 2003-76.

  Example
  Mom has an annuity contract with gross cash value of $200,000 and a tax basis of $80,000. If Mom assigns 50% of the contract in a partial exchange, the resulting two contracts will each have cash value of $100,000 and a tax basis of $40,000.

- In the partial exchange of an annuity contract for an LTC policy, the exchanged amount contains pro rata amounts of basis and gain. Rev. Rul. 2003-76.

  Example
  Mom has an annuity contract with a cash value of $200,000 and a tax basis of $80,000. If Mom does a partial exchange of 10% of the contract in a partial exchange for an LTC policy, the exchanged amount of $20,000 carries out $8,000 of the annuity contract's basis – 10% of the original basis of $80,000. After the exchange, the annuity contract has cash value of $180,000, and a tax basis of $72,000.

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