1035 Exchange

The replacement of an annuity or life insurance policy; i.e. the exchange of existing policies for new ones purchased from different companies without tax consequences, is called a Section 1035 Exchange. To retain the tax advantages of such an exchange, it must meet the requirements of Section 1035 of the Internal Revenue Code for the transaction to be tax-free. A 1035 Exchange allows the contract owner to exchange outdated contracts for more current and efficient contracts, while preserving the original policy's tax basis and deferring recognition of gain for federal income tax purposes.

Reasons for Using a 1035 Exchange:

- To avoid current income taxation on the gain in the "old" contract.

Generally, the surrender of an existing insurance contract is a taxable event since the contract owner must recognize any gain on the "old" contract as current income. However, under IRC Section 1035 when one insurance, endowment, or annuity contract is exchanged for another, the transfer will be nontaxable, provided certain requirements are met. The IRS has indicated through Private Letter Rulings that it will apply a strict interpretation to the rules. For a transaction to qualify as a 1035 Exchange, the "old" contract must actually be exchanged for a "new" contract. It is not sufficient for the policyholder to receive a check and apply the proceeds to the purchase of a new contract. The exchange must take place between the two insurance companies.

- To preserve the adjusted basis of the "old" policy.

Preserving the adjusted basis is preferable in situations in which the "old" contract currently has a "loss" because its adjusted basis is more than its current cash value. The adjusted basis is essentially the total gross premiums paid less any dividends or partial surrenders received. This basis carryover is important when the owner has a high cost basis in the "old" contract. For example, Jane Smith has a Whole Life policy she purchased 15 years ago. She paid $1,000 annual premium for the last 15 years and has received $5,000 in policy dividends. The policy currently has $6,000 in cash value. Jane's cost basis is $10,000 (15 x $1,000 less $5,000 dividends.) If Jane did not exchange the "old" policy for the "new" one, but rather surrendered it and purchased the "new" policy with the $6,000 surrender value, she would only have a $6,000 basis in the "new" policy. If, however, she exchanges the "old" policy, she will preserve the $10,000 cost basis.

Requirements & Guidelines

The owner and insured, or annuitant, on the "new" contract must be the same as under the "old" contract. However, changes in ownership may occur after the exchange is completed. The contracts involved must be life insurance, endowment, or annuity contracts issued by a life insurance company. These are the types of exchanges which are permitted: from an "old" life insurance contract to a "new" life insurance contract; from an "old" life insurance contract to a "new" annuity; from an "old" endowment contract to a "new" annuity contract; and from an "old" annuity contract to a "new" annuity contract. (Note: An "old" Annuity contract cannot be exchanged for a "new" life insurance contract.)

Two or more "old" contracts can be exchanged for one "new" contract. No limit is imposed on the number of contracts that can be exchanged for one contract. However, all contracts exchanged must be on the same insured and have the same owner. The adjusted basis of the "new" contract is the total adjusted basis of all contracts exchanged. The death benefit for the "new" contract may be less than that of the exchanged contract, provided that all other requirements are met. Face amount decreases within the first seven years of an exchanged may result in MEC status. When the face amount is reduced in the first seven years, the seven-pay test for MEC determination is recalculated based upon the lower face amount.

Under current tax law, contracts exchanged must relate to the same insured. Any addition or removal of insureds on the "new" contract violates a strict interpretation of the regulations. For example, you cannot exchange a single-life contract for a last-to-die contract or vice versa. Under certain circumstances you may exchange a contract with an outstanding loan for a "new" contract. This depends on the guidelines followed by the insurance company with whom the "new" contract is to be taken out. One possibility would be for the loan to be canceled at the time of the exchange. If there is a gain in the contract, cancellation of the loan on the "old" policy is considered a distribution and may be a taxable event. One way of avoiding this result would be to pay off the existing loan prior to the exchange.

Exchanging a deferred annuity for an immediate annuity qualifies for tax deferral under IRC Section 1035. However, avoidance of the 10% will depend upon which of the IRC Section 72 exceptions the client is relying upon:

1. Payments made on or after the date on which the taxpayer becomes 59½ will avoid the 10% penalty.

2. Payments that are part of a series of substantially equal periodic payments made for the life expectancy of the taxpayer or the joint life expectancies of the owner and his or her beneficiary will also avoid the 10% penalty.

3. Payments made under an immediate annuity contract for less than the life expectancy of a taxpayer who is under age 59½ probably will not avoid the 10% penalty.

IRC Section 72 requires that the immediate annuity payments begin within one year of the purchase. The IRS will most likely contend that the purchase date of the "new" contract will relate back to the date of the original purchase of the deferred annuity. Since it is unlikely the original annuity was purchased within one year of the "new" annuity's starting date, the payments will probably not qualify for this exception.