

Tax-Free Policy Exchanges (Sec. 1035)

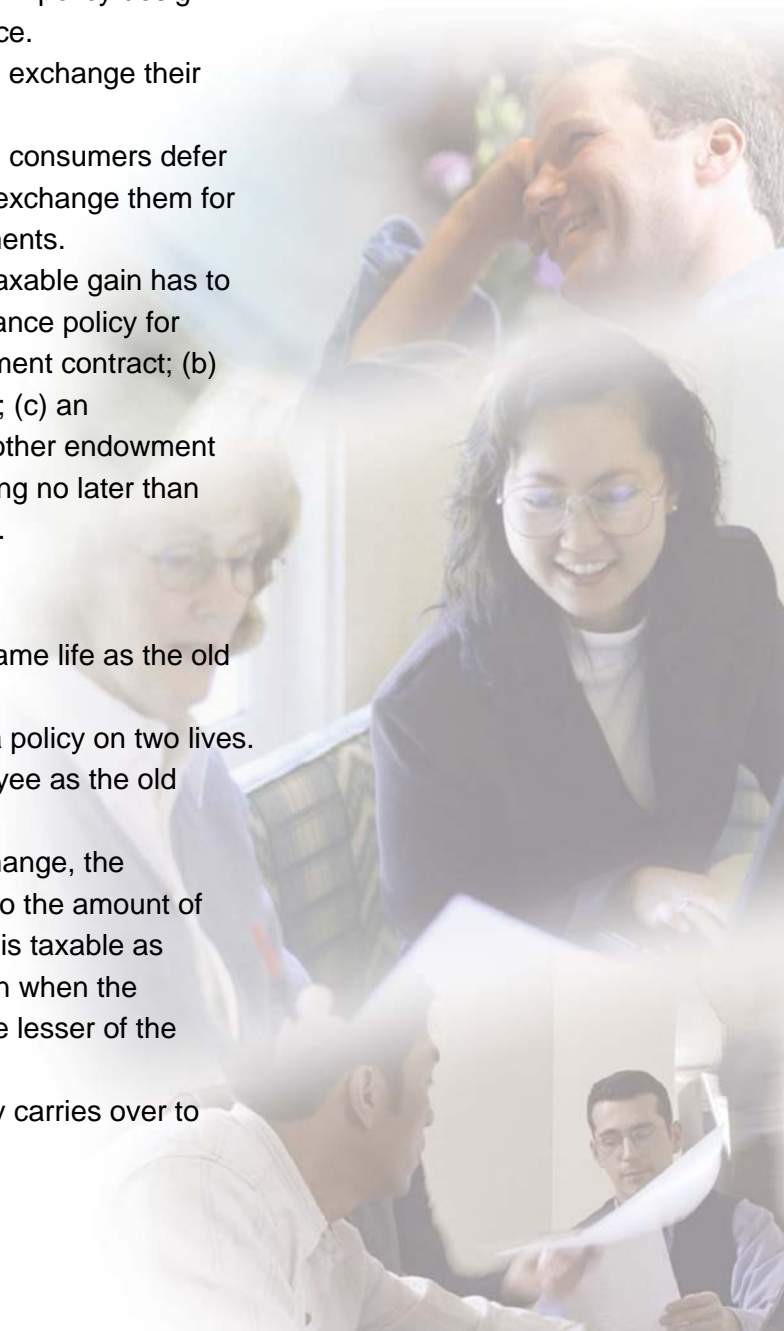


The Rationale...

- As life insurance policies evolve, improvements in policy design have enhanced flexibility, rate of return, and price.
- As a result, some consumers find it attractive to exchange their old policies for the newer policies.
- Section 1035 of the Internal Revenue Code lets consumers defer taxation of the gain in older policies when they exchange them for new ones, providing they meet certain requirements.
- When Section 1035 requirements are met, no taxable gain has to be recognized when exchanging (a) a life insurance policy for another life insurance policy, annuity or endowment contract; (b) an annuity contract for another annuity contract; (c) an endowment contract for an annuity contract or other endowment contract providing for regular payments beginning no later than the payments prescribed under the old contract.

The Requirements...

- The new life insurance policy must insure the same life as the old policy.
- A policy on one life may not be exchanged for a policy on two lives.
- A new annuity contract must have the same payee as the old contract.
- If cash or other consideration is part of the exchange, the transferor recognizes any gain in the policy up to the amount of cash or other consideration received. This gain is taxable as ordinary income. Existing loans that are forgiven when the exchange is made are considered income to the lesser of the gain or the loan.
- Generally, the income tax basis of the old policy carries over to the new policy.



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The Caveats...

Certain “red flags” should be examined before a 1035 exchange is carried out:

- Is the insured still insurable? Does the insured qualify for the new coverage at standard rates? The old policy shouldn't be terminated before insurability is determined.
- Does the old policy enjoy tax advantages that aren't available in the new policy?
- Does the old policy have an outstanding policy loan? Loans can complicate policy exchanges and may cause the policyowner to be taxed on the transaction.

The Bottom Line...

Exchanging older policies for new ones can make sense in many cases, and for many reasons. And providing certain requirements are met, Section 1035 of the Code adds still another reason for considering such exchanges. Consumers are encouraged, however, to consult their tax advisors before making a 1035 exchange.



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What Are Tax-Free Policy Exchanges?

Exchanging an old life insurance policy for a newer one is a frequent occurrence, often motivated by a desire to obtain higher rates of return, lower mortality costs, or additional policy features.

In buying a new policy, a consumer incurs new acquisition costs, which may mean that even a clearly superior new policy may not be a better deal until several years have passed. However, for owners of older policies, Section 1035 of the Internal Revenue Code helps the picture by letting consumers defer federal income taxation of the gain in older policies when they're exchanged for new ones, provided certain requirements are met. A Section 1035 exchange also transfers the basis of the existing policy to the new policy.

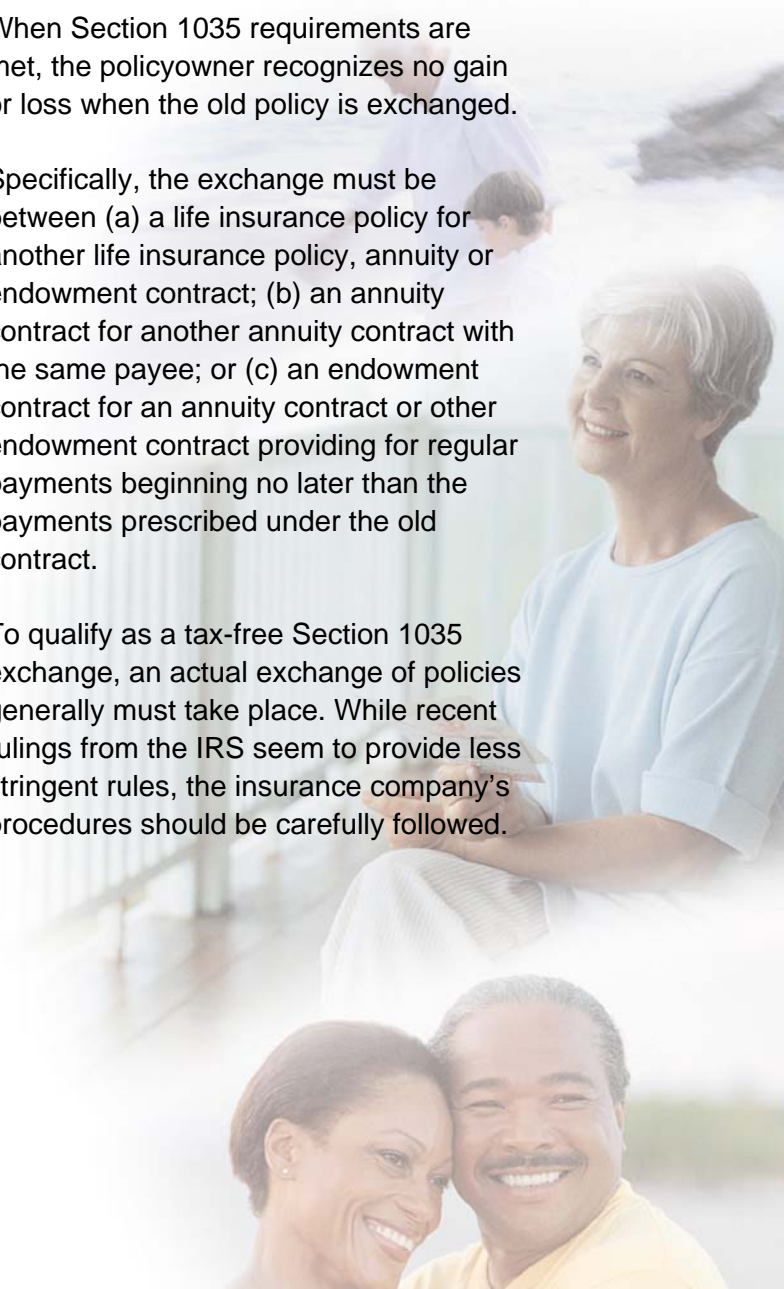
But there are caveats. Existing coverage should be carefully compared with reasonable projections of new policy values and benefits, and the pros and cons carefully considered before an exchange is made.

How Do Tax-Free Policy Exchanges Work?

When Section 1035 requirements are met, the policyowner recognizes no gain or loss when the old policy is exchanged.

Specifically, the exchange must be between (a) a life insurance policy for another life insurance policy, annuity or endowment contract; (b) an annuity contract for another annuity contract with the same payee; or (c) an endowment contract for an annuity contract or other endowment contract providing for regular payments beginning no later than the payments prescribed under the old contract.

To qualify as a tax-free Section 1035 exchange, an actual exchange of policies generally must take place. While recent rulings from the IRS seem to provide less stringent rules, the insurance company's procedures should be carefully followed.



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What if the Old Policy Has a Loan Outstanding?

Another caveat: Section 1031(b) of the Internal Revenue Code provides that gain from exchanges "not solely in kind" will be taxable.

This section says that when the policy to be exchanged has a policy loan outstanding, then the amount of that loan paid off in the exchange will be taxable up to the amount of gain in the contract.

If a policy to be exchanged has an outstanding loan—and if there is gain in the contract—the most common ways to avoid a taxable gain are either to pay off the policy loan prior to the exchange, or to have the new policy be subject to the same loan amount as under the old policy. However, this isn't always possible.

Policy exchanges in today's economic climate can be a good idea in many cases. But consumers are encouraged to consult their tax advisors—especially if there are loan situations involved.



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