

Ralph's Term Look-alike Universal Life

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Twelve years ago Ralph purchased a universal life insurance contract, paying premiums of \$5,000 per year. This policy offered no cash value for the first 20 policy years, and as such it was essentially equivalent to a level premium annually renewable term insurance contract (and probably sold on that basis), but was filed with regulatory authorities as a universal life product. (This type of universal life (UL) contract, sometimes referred to as term look-alike, was commonly offered when Ralph purchased his policy.)

Twelve years have now passed, and Ralph is about to replace this policy with a new product recommended by his insurance advisor, Joe. Joe prepares an application for the new policy, and Ralph signs it and submits the initial premium. The new policy is issued and the old policy is simply allowed to lapse. Should anything more have been done?

What are the issues?

Like other assets, life insurance contracts have a tax basis in the hands of the policy owner. It is commonly accepted that the basis of an insurance contract includes all of the premiums paid in, and that this cost basis is used as the recoverable investment in the contract for purposes of the computation of any gain on the taxable disposition of a policy and the determination of the portion of cash value withdrawals that represent tax-free cost recovery. In general, this measure of basis is applicable without regard to the policy's cash value at any given time.

As is the case with other forms of tax-deferred exchange transactions, when a life insurance contract is exchanged for another life insurance contract in a tax-deferred exchange transaction under I.R.C. Section 1035, the basis in the newly acquired policy is equal to the basis in the old policy at the time of the exchange, plus any premiums paid with respect to the new policy.

This carryover basis rule is a fundamental aspect of sales, exchanges or other dispositions of property in which no gain is recognized for tax purposes. It is through the carryover of a below-market-value basis that any unrealized gain at the time of the exchange is effectively deferred for potential taxation when the asset is disposed of in a taxable transaction. However, the carryover of basis can operate to the taxpayer's advantage in situations in which the holder of a life insurance policy intends to replace it with a new policy — even in instances where surrender of the old policy would not result in any taxable gain.

What Ralph should have done

In the above facts, no thought was ever given to exchanging the old policy for the new one. Section 1035 exchanges of insurance policies are typically employed only in situations where the policy given up has a cash value great enough that a taxable gain would be realized upon its surrender. In Ralph's case, the cash value was zero, even though there was a \$60,000 basis in the surrendered contract.

But by surrendering or lapsing the old UL (term look-alike) policy, that \$60,000 of basis is forever lost. What if Joe were to have taken an extra step and structured the sale of the new policy as an exchange for the old UL policy? This would seem to involve no more than a bit of additional paperwork, but could provide the client, Ralph, with a potentially valuable tax benefit down the road — a \$60,000 increase in the basis in the new policy from day one. The practical effect is that Ralph could enjoy \$60,000 more in tax-free withdrawals from the new contract in future years.

This potential preservation of basis by simply completing additional paperwork to effect a Section 1035 exchange is often overlooked when replacing low cash-value universal life policies or UL term look-alike contracts with no cash value. Since it has long been accepted that a life insurance contract has a tax basis equal to the aggregate premiums paid — without regard to the level of the cash value at any particular time — policyholders who simply terminate their old policy at the time of replacement with a new one are wasting an opportunity to transfer that basis to the new policy, with potentially substantial benefits down the road.

In the case of the term look-alike product it seems that a UL to UL 1035 exchange results in a carryover of basis from the policy given up to the new policy. Yet, this opportunity to preserve basis is often overlooked!

The point made in the preceding paragraphs — that preservation of basis through a Section 1035 exchange can provide a substantial future tax benefit for insurance clients — is the central message of this case study.

It is important to note that the focus is on exchanges of universal life for universal life (or life insurance contracts other than term). This includes even those so-called term look-alike contracts that the insureds may have always viewed as term insurance but are actually UL contracts with no cash value.