ADVANCED MARKETS INSIGHT

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How wealth works.

Eslick Financial Group, Inc. provides sophisticated insurance and wealth management services to families, business owners, corporate executives, professionals, and other successful high income and high net worth individuals. Our team of professionals utilizes a customized process of defining, understanding, researching, evaluating, and informing our clients of innovative and uniquely integrated solutions tailored to their diverse financial goals. Our desire is to help make the otherwise complex, more understandable as it applies to your unique situation.

Tax-Deferred Exchanges of Life Insurance under Section 1035

A primary advantage of cash value life insurance ownership is the ability to replace an existing policy sometime in the future. There are many reasons for exchanging an existing contract, including an opportunity for enhanced performance, as well as more robust features and benefits that align better with your needs. Under Internal Revenue Code (IRC) Section 1035, a properly transacted exchange can result in deferred taxation of any accumulated gain until the owner surrenders (or otherwise disposes of) the newly acquired policy.

Reasons to Consider a Policy Exchange

There are many reasons to consider an exchange of an existing policy. Exchanging for a new policy can:

- Reduce premiums and/or increase death benefit coverage.
  - Older policies may use an outdated mortality table. Newer products using the current tables have reduced mortality costs.
  - Built-in costs of newer life insurance policies are generally lower.
  - The insured may qualify for better rates due to health improvements (i.e., the insured is no longer a smoker).
- Replace a policy not performing as projected.
- Cover an insured for an extended duration to address concerns surrounding outliving the existing policy.
- Transition to a carrier with better ratings and financial stability.
- Facilitate a change in insurance needs (e.g., policyowner now desires guaranteed death benefits).

Tax-Deferred Exchanges under Section 1035

Section 1035 of the IRC states that no gain or loss shall be recognized on the exchange of a contract of life insurance for a) another contract of life insurance, b) an endowment[1], c) an annuity contract, or d) a qualified long-term care insurance contract.

General Requirements

- The insured party in the new policy must be the same as the insured party in the previous contract. (i.e., a single life policy must be exchanged for another single life policy, or a survivorship policy must be exchanged for a survivorship policy).
- The owner of the policy must remain the same both before and after the exchange.
- The owner of the policy must be a citizen of the United States.

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1 An Endowment contract is defined as a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

Factors to Consider

The "Boot" Consideration

In most circumstances, the replacement of a life insurance policy with a new life insurance policy will result in the policyholder owning a new contract with a basis equal to that of the original contract, and will defer recognition of any taxable gain. However, the IRS has described circumstances where the policyholder receives not only a new insurance policy, but some additional payment of cash or other property as a result of the exchange. The IRS refers to these additional amounts as "boot." If the policy holder receives "boot" in an otherwise tax-free exchange, gain will be recognized to the extent of the boot received.

Exchanges of Policies with Outstanding Policy Loans

Life insurance policies with outstanding policy loans require special care during replacement in order to avoid tax consequences. Although there are no specific provisions in the IRC on how policies with outstanding loans will be handled during an exchange, a series of Private Letter Rulings have indicated that the IRS will consider any portion of a loan discharged in the process as "boot."[2]

Therefore, the policyholder has two options when exchanging a policy with an outstanding loan:

1. Pay off the loan prior to the exchange. Although a loan payoff may seem like a practical option, it is important to keep in mind the IRS is wary of efforts to circumvent the application of "boot" treatment to policy exchanges. As such, repayment of loans in close proximity to a 1035 exchange is a generally inadvisable practice and should not be considered as part of a unitary plan to avoid income tax. This is true regardless of whether the funds to repay the loan come from the original policy, the new policy, or the policyholder's own funds.
2. Carry the loan over to the new policy. Many insurance companies will allow for a policy loan to be carried over to the new policy. If the outstanding loan is carried forward to the new policy, the exchange is tax-free and no "boot" needs to be recognized. However, not every insurance company will allow a loan to be carried over, and this should be confirmed prior to commencing the replacement process.

Additional Considerations

- The new policy will contain a new two-year incontestability period.
- The new policy will be issued with a surrender charge period that may last 7-20 years.
- A replacement will create a new seven-year excessive premium test. Policies failing the test are subject to adverse tax consequences.
- In order to justify the replacement, the benefit achieved must outweigh the acquisition costs.
- In order to qualify for a replacement policy, the insured must undergo underwriting.

Conclusion

There are many valid reasons to consider replacing an existing cash value insurance policy. Section 1035 offers policyholders a way to do so while preserving basis and tax deferral of any gain. As these replacements may involve a number of financial and tax factors, it is important to consult an experienced life insurance professional who can provide the insight and experience necessary to produce successful results.

2 Treasury Regulation § 1.1035-1(c); Internal Revenue Code 1031(b) and(c)

For More Information

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