2026 **Advanced Sales Forum**

Rooted in Knowledge — Aligned for Growth

1035 Exchanges… and other owner and beneficiary stuff!

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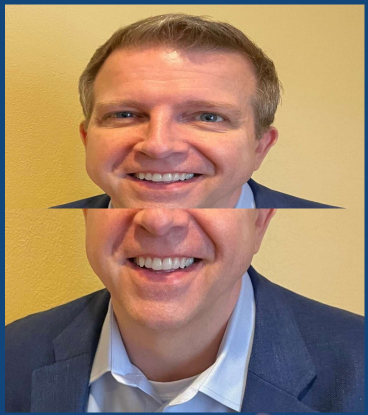

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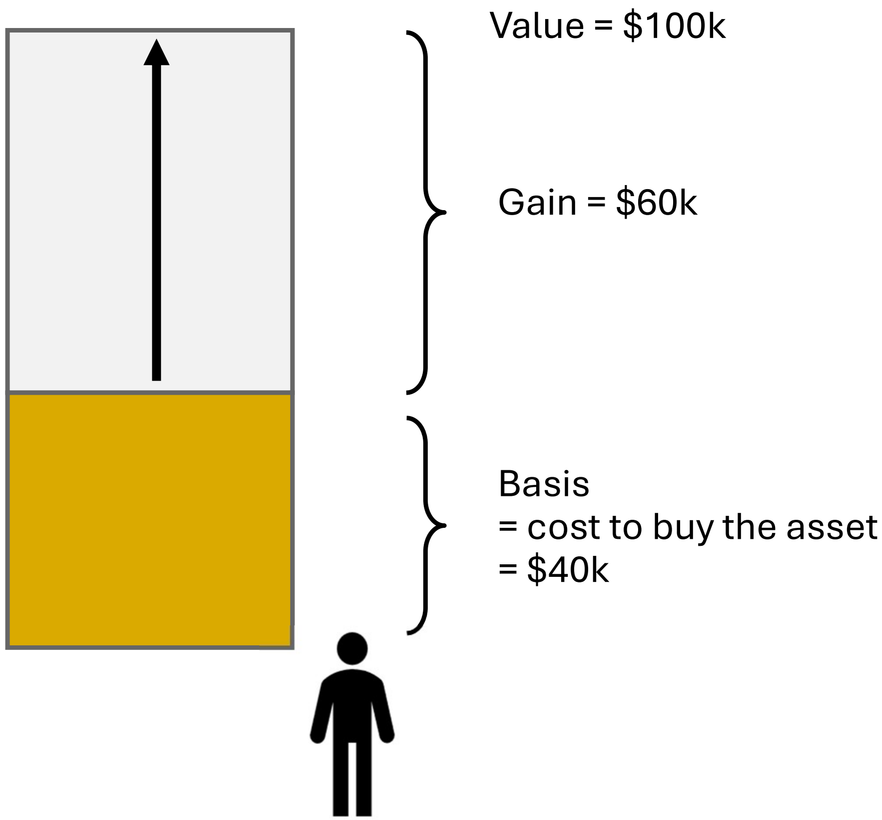
Let’s say owner pays $40k for an asset, and its value later increases to $100k



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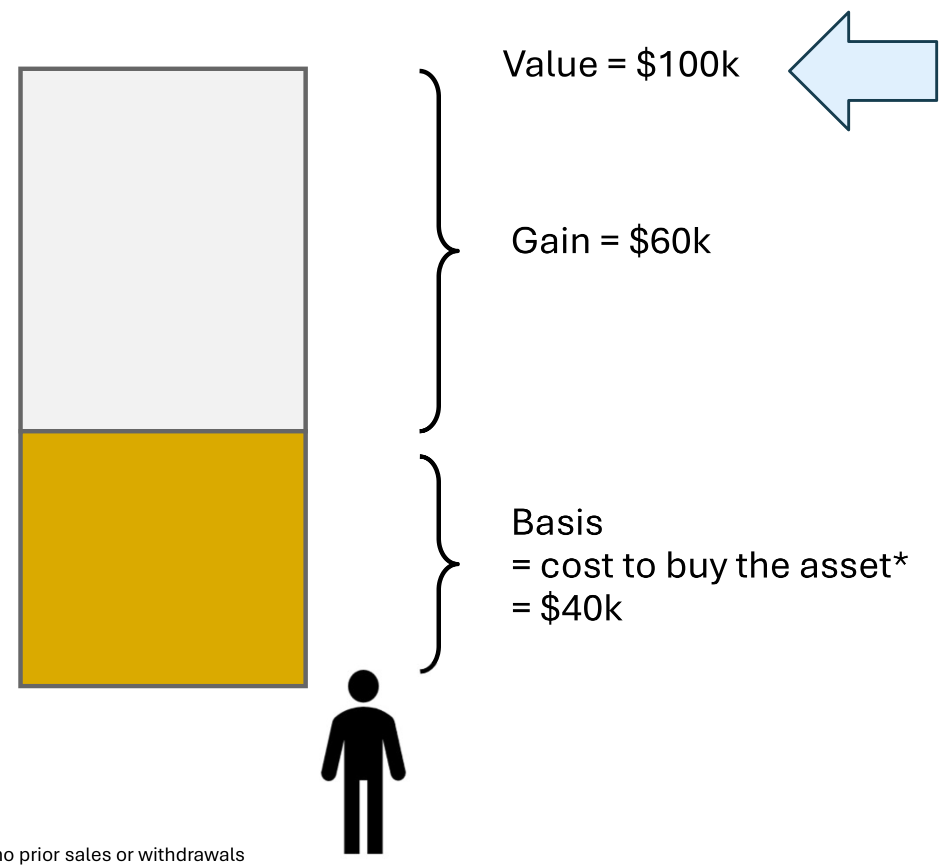
Taxable gain = amount received, minus basis in asset relinquished



What is the tax effect if one were to sell or exchange (or otherwise relinquish) for:

. . . $100k cash from Ins Co.?

. . . $100k cash from 3rd party buyer?

. . . Oil painting worth $100k?

. . . Fancy vase worth $100k?

. . . Pretty much anything, whether cash or asset, worth $100k?

The result is the same: the owner realizes gain (or loss) on the sale or exchange.

*Assumes no prior sales or withdrawals

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some tax basics of life insurance
. . . and impacts of a
Modified Endowment Contract (MEC)

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Premiums, growth, and death benefit

RULE	AUTHORITY
Premiums are not income tax deductible	IRC § 264(a)(1)
Cash value not taxed as it grows	*See* IRC § 72 *Cohen v. Commissioner*, 39 T.C. 1055 (1963) *Griffith v. Commissioner*, 35 T.C. 882 (1961)
Death benefit normally received income tax free	IRC § 101(a)(1)

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Policy withdrawals

- Policy withdrawals / distributions
  - dividends in cash
  - partial surrenders
  - policy reductions

- Generally, withdrawals are **first-in, first-out (FIFO)**. IRC § 72(e)(5).
  - First, reduce basis tax-free
  - Second, after exceeding basis, then taxed at ordinary income tax rates

- Exceptions to the general FIFO rule:
  - Forced-out gain (potential if withdrawal in first 15 years). IRC § 7702(f)(7)
  - Life policy that is a Modified Endowment Contract (MEC). IRC § 7702A

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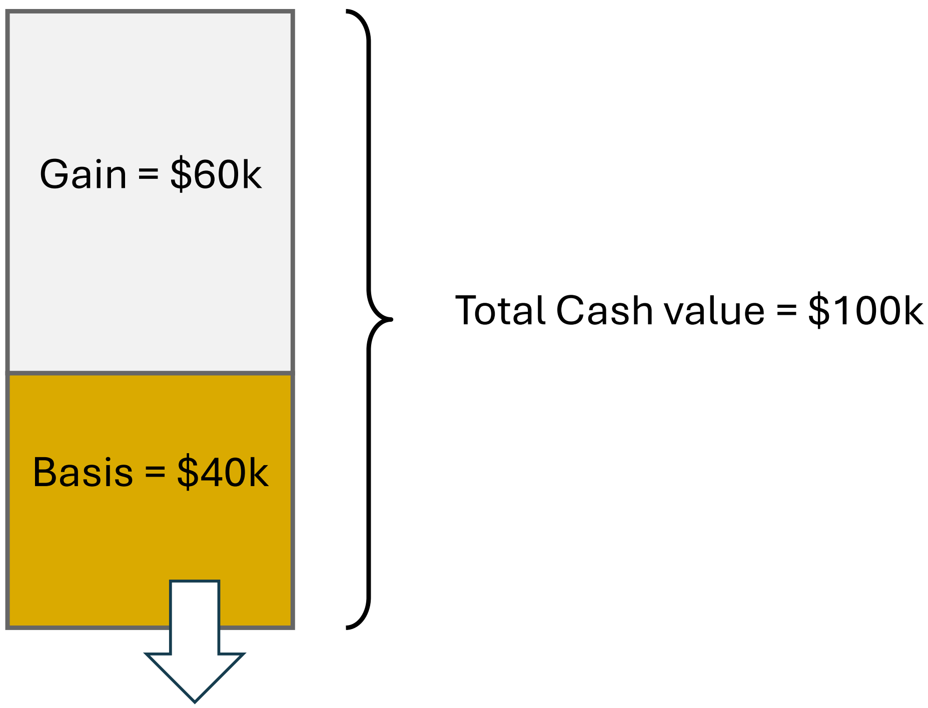
Policy withdrawals – general FIFO rule



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Policy loans = borrowing from policy

- Can usually borrow up to certain amount (90-95%) of cash value

- Tax effect of policy loan* –
  - not income taxable
  - no effect on basis in policy (except if use loan dollars to pay premiums)
  - reduces cash value and reduces death benefit (dollar-for-dollar)
- Interest –
  - generally, not deductible
  - non-paid interest is added to the loan balance

- Surrender Squeeze: When loan gets too large, then –
  - insurance company will surrender the policy (lapses)
  - policyowner taxed on all built-in gain (as the policy loan is treated as a deemed distribution)

*Assumes the policy is not a MEC.

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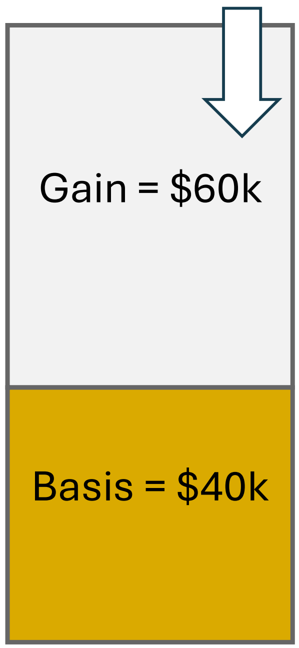
MEC policy withdrawals – LIFO rule



MEC Withdrawals

- Gain-first
    - "ladling from the top"
    - "cheese slicer"
- Does not increase basis
- If withdrawal exceeds the built-in gain, the "excess" portion is not income taxed, but does reduce basis

Loans from MECs

- Policy loan treated as gain-first withdrawal
    - Pledging policy (collateral assignment) taxed too
    - Whatever is taxed here <u>does</u> add to basis

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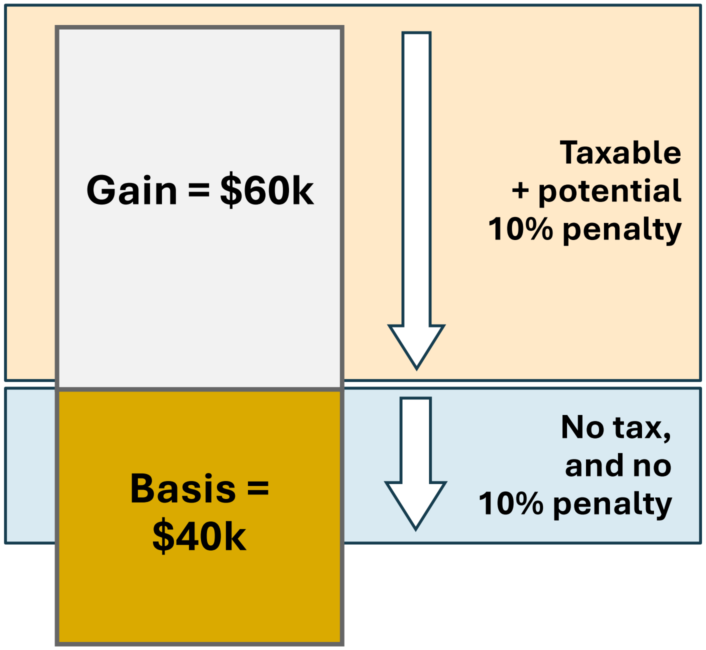
10% penalty for MEC withdrawals (or policy loans or pledging)



Taxable portion of withdrawal is subject to additional 10% tax.

- The 10% penalty (additional) tax applies, unless –
  - taxpayer over age 59.5
  - taxpayer disabled
  - series of substantially equal periodic payments over life or life expectancy of taxpayer
- Age, disability, etc. of insured is not important.
- If trust owned, then might meet exception if “grantor trust” and grantor is over age 59.5.
- If business-owned, then never meet above exceptions

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1035 exchanges
… the basics

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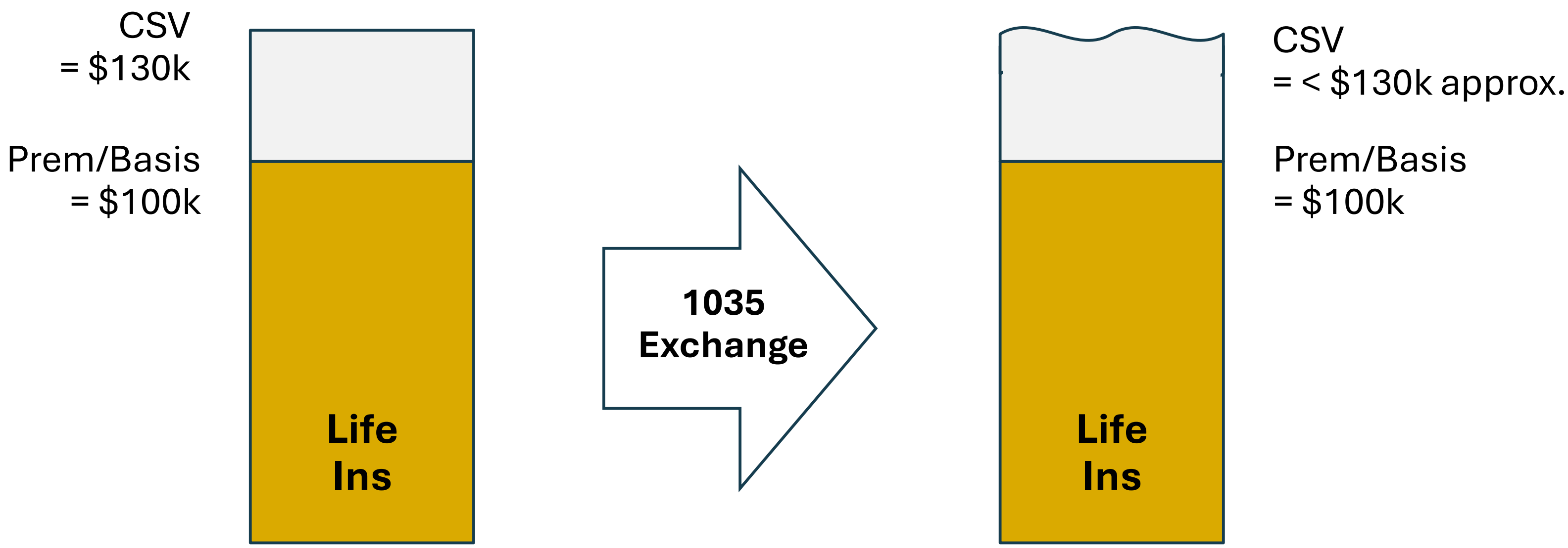
1035 exchange – typical example



- No gain or loss recognized
- CSV of $130k sent over to new contract . . .

  . . . but CV of new policy likely lower due to loads, fees, charges, and commissions on new contract.
- Resulting policy has carryover basis of $100k.

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Section 1035 tax-free exchanges

- Section 1035 “like-kind” exchange is exception to normal rule that “sale or exchange” of any life insurance triggers income tax on built-in gain.

- Similar to Section 1031 exchange for real estate

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1035 Hierarchy: permissible tax-free exchanges

- From **Life Insurance** to:
  - Life Insurance
  - Endowment Contract – irrelevant, as no one sells these anymore; don't meet life ins definition
  - Annuity Contract
  - Long-Term Care (LTC) insurance

- From **Endowment Contract** to:
  - Endowment Contract – irrelevant, as no one sells these anymore; don't meet life ins definition
  - Annuity
  - Long-Term Care

- From **Annuity** to:
  - Annuity
  - LTC insurance

- From **LTC insurance** to:
  - LTC insurance
  - But you'll have a hard type finding LTC insurance that can be surrendered for cash, so pretty irrelevant

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1035 exchanges … upside, downside (or at least neutral)

- Upside:
  - No gain or loss recognized.*
  - Basis carries over (helpful even if policy has no gain; retain high basis).
  - Resulting policy much less likely to become MEC if lump sum comes via 1035 vs. out-of-pocket (special 7-pay MEC test).

- Downside (or neutral):
  - 1035 re-starts 7-pay testing for MEC
  - 1035 re-starts 15-year clock for IRC 7702(f)(7) forced-out-gain rule.
  - Note: if already a MEC, 1035 will not cure it (“once a MEC, always a MEC“)

*If amount received by a policyowner or a policy loan is extinguished, the amount may be considered "boot" addressed in later slides.

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Section 1035 exchanges – main rules

- To be "like-kind," **insured(s)** on source contract **must be same as insured(s)** on resulting contract. Treas. Reg. § 1.1035-1.
  - **OK:** variable to fixed to universal life, and vice versa (whatever combination).
  - **OK:** one contract into many; many contracts into one contract.
  - **OK:** 1035 into existing contract. Rev. Rul. 2002-75
  - **OK:**
    - single life to single life.
    - joint life (survivorship) to joint life (survivorship).
  - **Not OK:**
    - single life to joint life (survivorship), or joint life (survivorship) to single life. PLR 9542037.
    - except - if one insured on survivorship policy is deceased, then survivor to single is okay. PLRs 9330040 and 201304003.

- Money from the surrendering insurance company must go directly to the new insurance company. Rev Rul 2007-24.

- 1035 regulations explicitly require the **insured** on source policy be same as **insured** on resulting policy.

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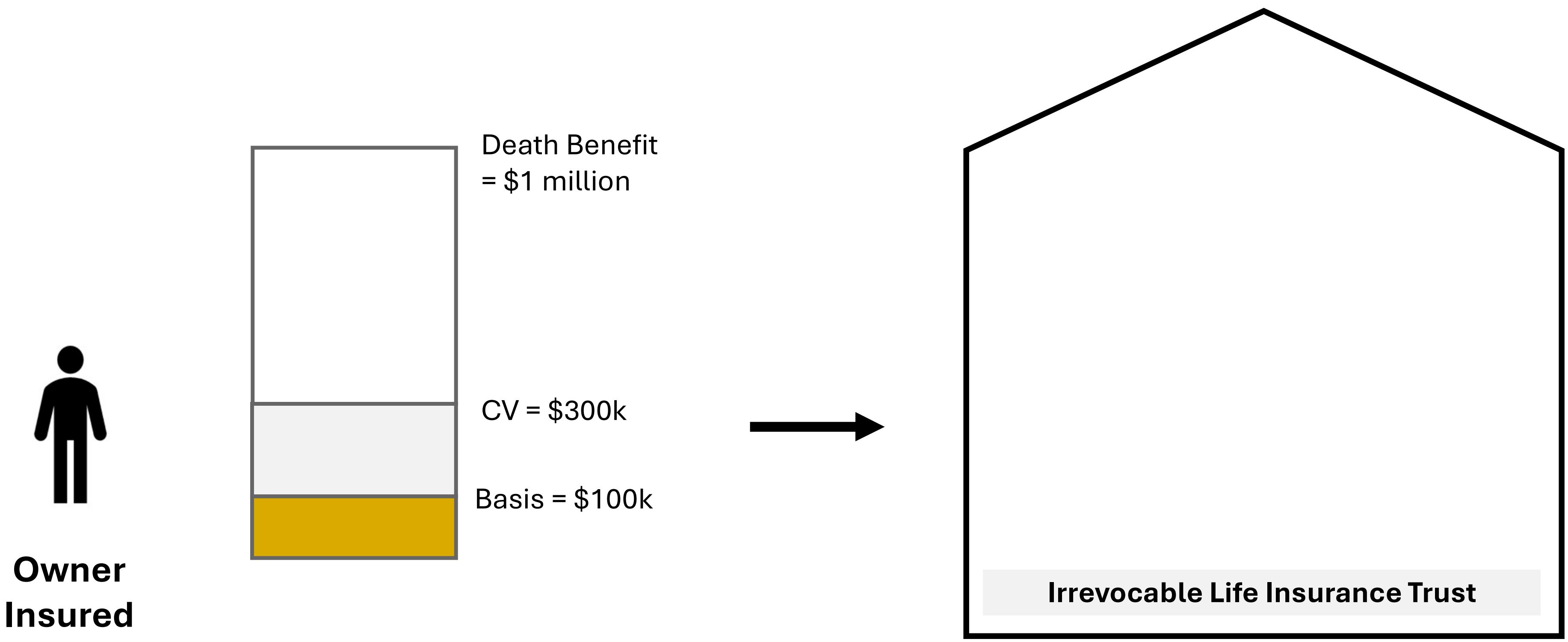
Can you “1035 into an ILIT”?



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To “1035 into” an ILIT is really two separate events

- 1035 exchange of a policy

- transfer of a policy into the ILIT.

Q: Which should the policyowner do first?

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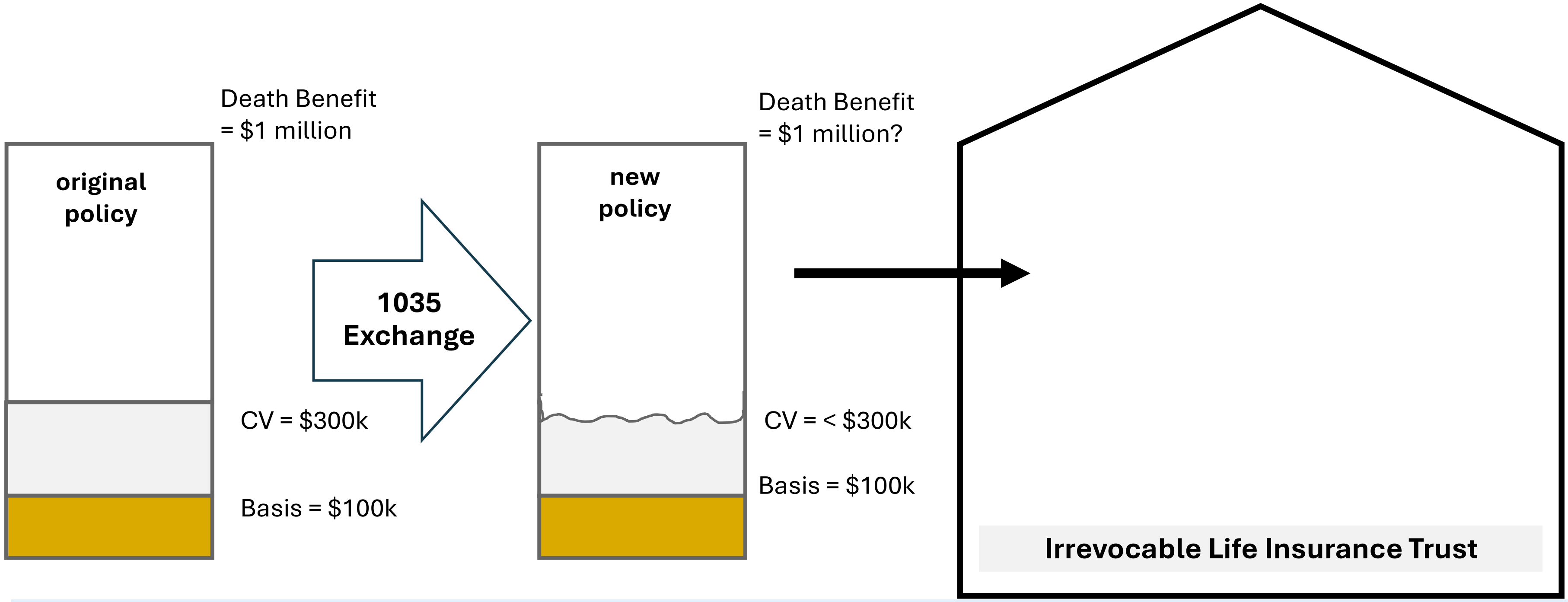
Some suggest you carry out the 1035 first, and then gift the policy to the ILIT



Argument: New policy after the 1035 exchange will have a lower value than original policy, thus lower gift tax value.

But: (i) Gift tax regulation says gift is “amount paid for policy” when buying policy for another (some say applies to gifts of policies that are < 1 year old); (ii) accepting 3-year-look-back rule and (iii) value of new policy might be higher.

This approach may be viewed as a potential planning consideration in certain circumstances. Appropriate treatment depends upon the client's facts, objectives, and applicable tax and estate planning considerations.

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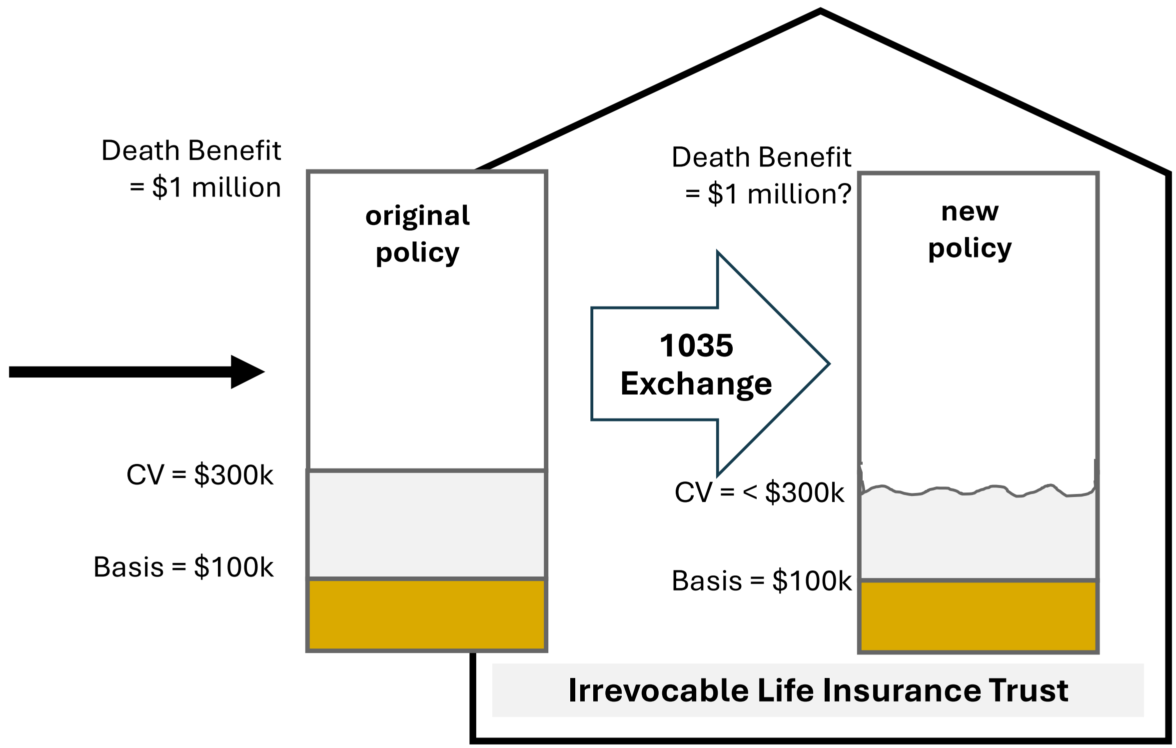
Others suggest giving the original policy first, and then the ILIT does the 1035

Argument: To give policy first won't change the gift tax effect much; or gift may be lower.

But having **the ILIT** carry out the 1035 exchange potentially "severs" the estate tax 3-year-look-back rule, as the ILIT will then own a "new" policy that the insured never owned or gave to the ILIT.

But: The argument that the 1035 severs the "new" policy from the "original" policy for purposes of the 3-year-look-back rule is untested.



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1035 exchanges of annuities

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Who the heck is the "obligee"? The annuitant? The owner?

- Treasury Regulation § 1.1035-1 states that:
  - For life-to-life exchanges, the "insured" must remain the same.
  - For annuity-to-annuity exchanges, the "obligee" must remain the same.

- For annuities, does "obligee" refer to the **annuitant**? Or instead to the **owner**?

- Most insurance companies play it safe, and require that any 1035 exchange of an annuity –
  - the **annuitant** on the original/source contract **must be the same annuitant** on the resulting/new contract, and
  - the **owner** on the original/source contract **must be the same owner** on the resulting/new contract.

Certain authorities, carrier practices, and professional commentators may reach different conclusions on these issues. No representation is made that a particular interpretation will be accepted by the IRS, a court, a regulator, or an insurance carrier.

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Reasons to view the annuitant as the "obligee"

- Analogy. The annuitant seems to be the measuring life on an annuity just as the insured is the measuring life on a life insurance policy.

- Like-kind. Changing the annuitant appears contrary to the "like kind" requirement of a tax-free exchange.

- Common sense. Any like-kind exchange statute inherently deals with tax effect to the owner who exchanges one an asset for another.
  - It is already assumed that the **owner** would not be changing.
  - The question is whether the assets exchanged by this one owner are like-kind.

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Reasons to view the <u>owner</u> as the "obligee"

- In plain English terms, the insurance company owes its obligations to the <u>owner</u> of the contract, not necessarily to the annuitant. So, owner is "obligee."

- IRC § 72(s) and its "trust held" annuity provisions imply that "obligee" is the owner.
  - IRC § 72(s) RMD rules force distributions from annuity after death of the contract's "holder."
  - But when a trust "holds" the annuity, these RMD rules are triggered by death of annuitant, **or by the mere changing of the annuitant.**
  - RMDs must occur over multiple years, <u>spreading the income tax over multiple years</u>.
  - If changing of the annuitant already meant it were not a valid tax-free 1035, then –
    - all the annuity's gain would be taxed <u>immediately</u>.
    - There would be no need to trigger 72(s) and its distributions and corresponding income tax over many years; all the gain would have already been taxed.

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Viewing "obligee" as the annuity's owner provides options

Whenever the owner is not the annuitant on a nonqualified deferred annuity, and only the annuitant dies, some insurance companies permit the still-alive owner to <u>select a new "contingent" annuitant and keep the contract in deferral</u>.

- Might be useful if original annuitant (say, owner's spouse or parent) was nearing the contract's maturity age. Permits owner to select much younger annuitant (say, child) and keep contract in deferral for many more years.

- This does not mean the contract can assuredly stay in deferral until that small child reaches the contract's maturity age (say, age 85).
  - The owner of the contract would not have changed. That owner will get older and eventually die.
  - The death of any owner ("holder") of a nonqualified annuity triggers the post-death RMD rules of IRC § 72(s).

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Viewing “obligee” as the annuity’s owner provides options *(cont’d)*

Ambiguity of “obligee” can be helpful if 1035’ing from nonqualified deferred annuity to LTC insurance.

- Consider a cash-rich deferred annuity where Husband is owner and is also annuitant.
- Husband wants to do tax-free 1035 into LTC insurance contract <u>where insured on new LTC contract will be Wife</u>.
- Perhaps Husband can 1035 from this annuity to LTC contract, where:
    - Husband is owner (so “obligee” remains the same), but
    - where Wife is insured on new LTC insurance contract.
- Then later, if so desired, Husband can give ownership of LTC contract to Wife (insured on LTC). Transfers between spouses are not income taxable.

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What does your company do?

QUESTION:

- At your insurance company, is the "obligee" viewed as . . .
  - Annuitant?
  - Owner?

- Or is the question avoided by always requiring that, in the exchange, the annuitant/insured remain same, and that owner remain same?

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watch out for “boot”

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1035s and “boot”

- If the policyowner receives anything else in addition to a new contract (i.e., “boot”) then there is potential income tax.

- "Boot"- includes cash and a **policy loan that’s extinguished in the exchange**.

- The policyowner is income taxed on whichever is lower …
  - boot (amount of policy loan extinguished), or
  - gain in source / surrendered policy.

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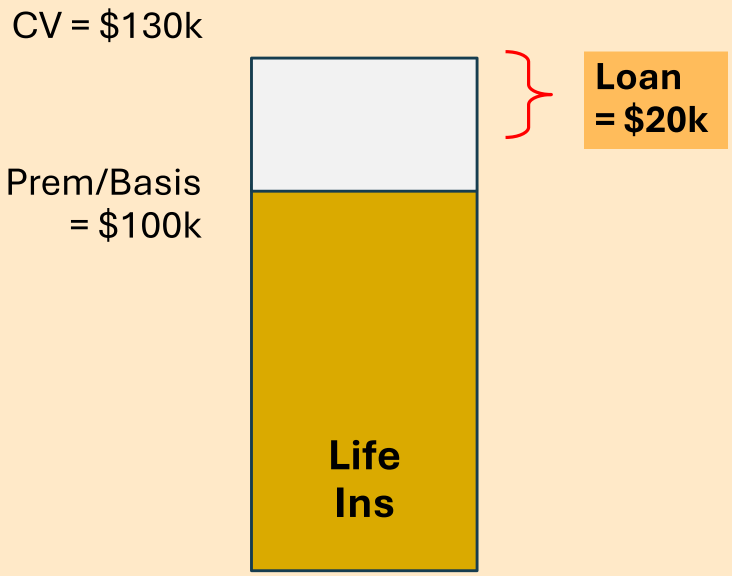
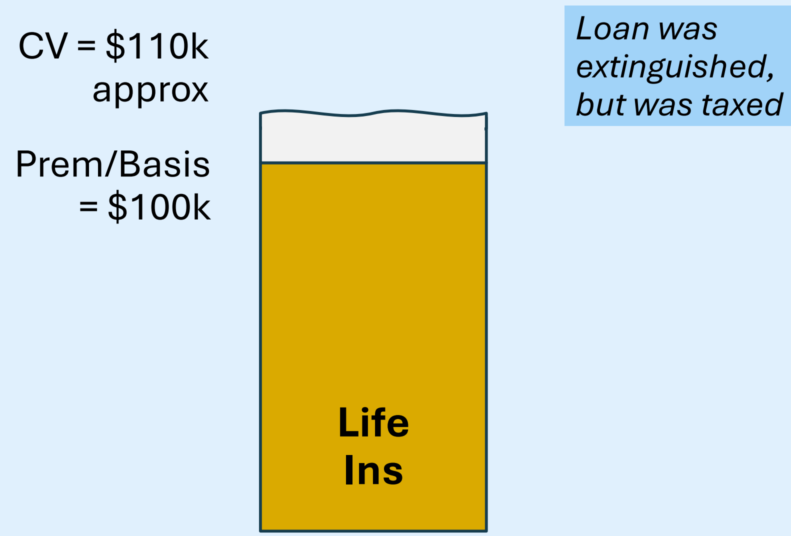
1035 of life policy with loan (assume loan extinguished in exchange; boot)



- **If 1035 this policy as-is, then $20k loan extinguished.**
- **Owner taxed on $20k, because loan is repaid "off the top" (LIFO; gain-first).**
- **Net CV of $110k paid into new/resulting contract).**



- **Resulting policy receives $110k.**
- **But CV of new policy likely lower than $110k due to loads and fees and charges and commissions.**
- **Resulting policy would have carryover basis of $100k.**

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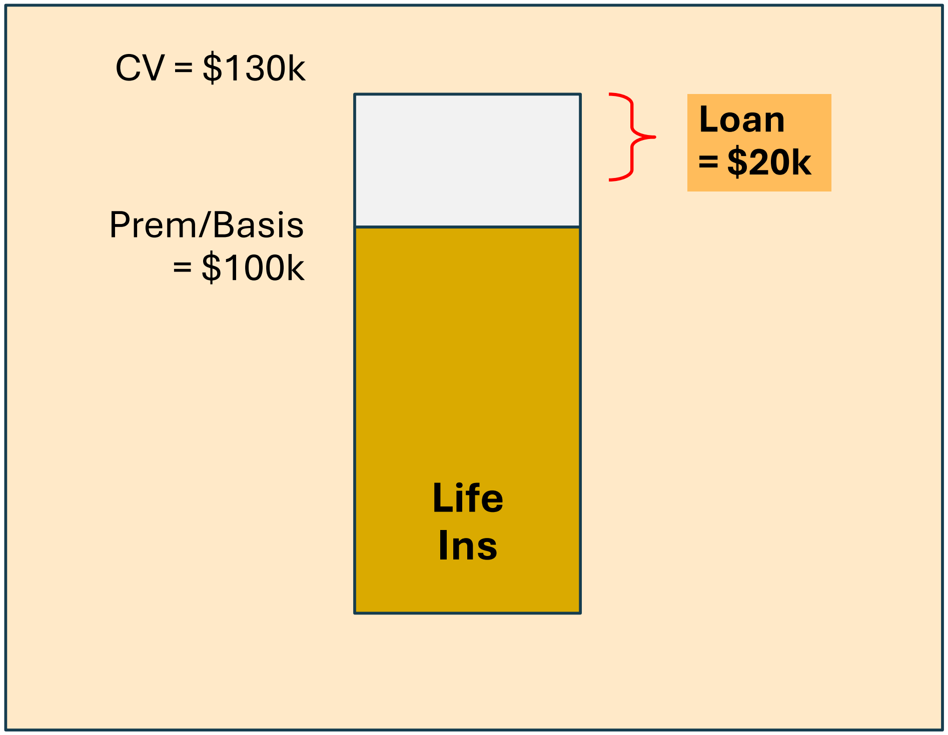
What about repaying loan first … then later 1035'ing?



Idea:

- First, take withdrawal from policy to repay the loan of $20k.
- Like poking hole in bottom of glass (FIFO; tax-free basis first).
- Resulting values:
  - CV reduced by $20k, from $130k down to $110k
  - Basis reduced by $20k, from $100k down to $80k

The discussion is intended solely to describe potential tax issues identified in authorities, insurer practices, and commentary. It should not be interpreted as guidance regarding how to structure a transaction or avoid tax consequences in any particular situation.

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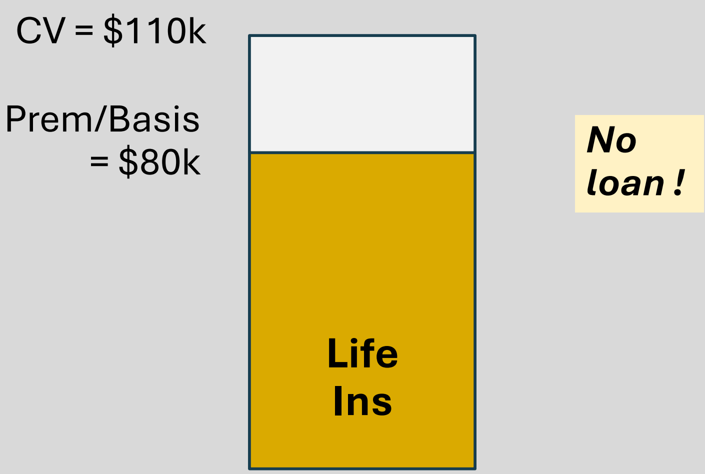
What about repaying loan first … then later 1035'ing? *(cont'd)*

After loan repaid using policy withdrawals under the normal FIFO method, the resulting policy would look like this:



Q: Can owner then 1035 exchange this (loan-free) policy without taxation?

- Yes, but watch out for **step-transaction** rule!
- IRS may collapse into one taxable transaction
- No clear "safe" wait time to be treated as separate transactions.

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What about repaying loan first … then later 1035'ing? *(cont'd even more)*

As for potential "step transaction" doctrine:

- Some insurers issue 1099 for 1035 exchange if wait 30 or 60 days between steps
- Others issue 1099s showing taxable loan extinguished if both occur <u>in same tax year</u>

<u>LESSONS:</u>

- Ask receiving insurance company if they'll issue new policy with loan, so it is not extinguished in exchange, and there is no "boot."
- If new insurance company won't issue policy with loan, then <u>before</u> policyowners withdraw from the policy to repay a loan followed by a 1035 … <u>first find out</u> from the surrendering insurance company what will be on the 1099.

<u>QUESTION:</u>

What does your insurance company do?

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if policy has no gain, should taxpayer bother to do a 1035 exchange?

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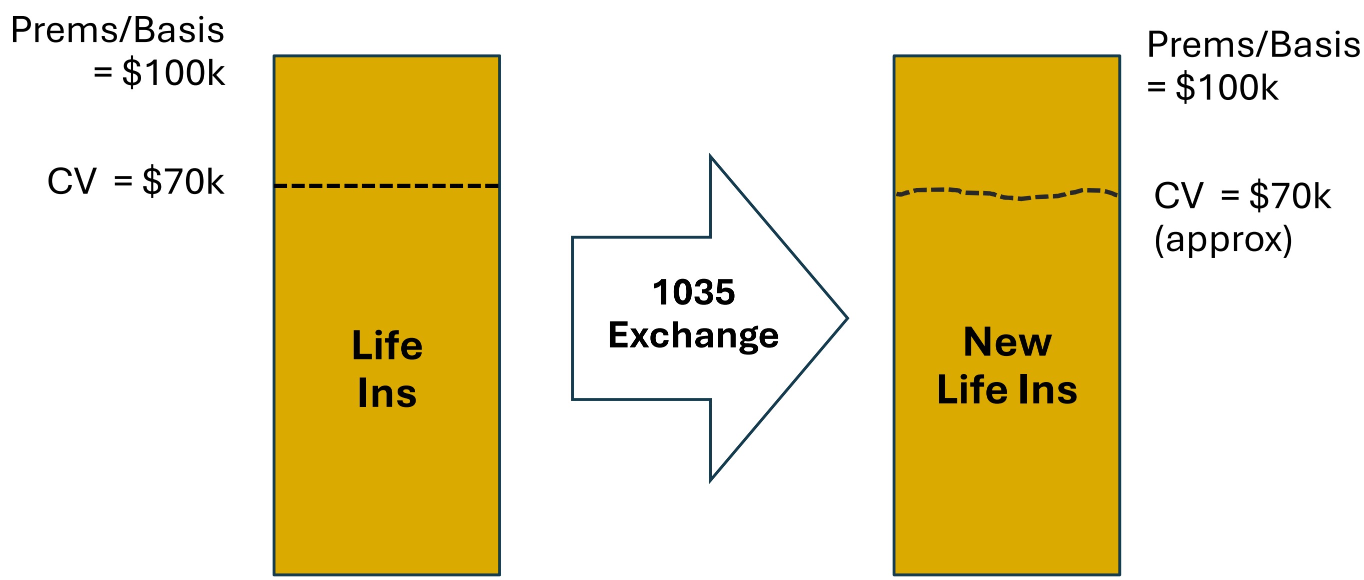
1035'ing policy that has no gain (underwater)



Upsides:

- Preserve high basis
- Better MEC testing

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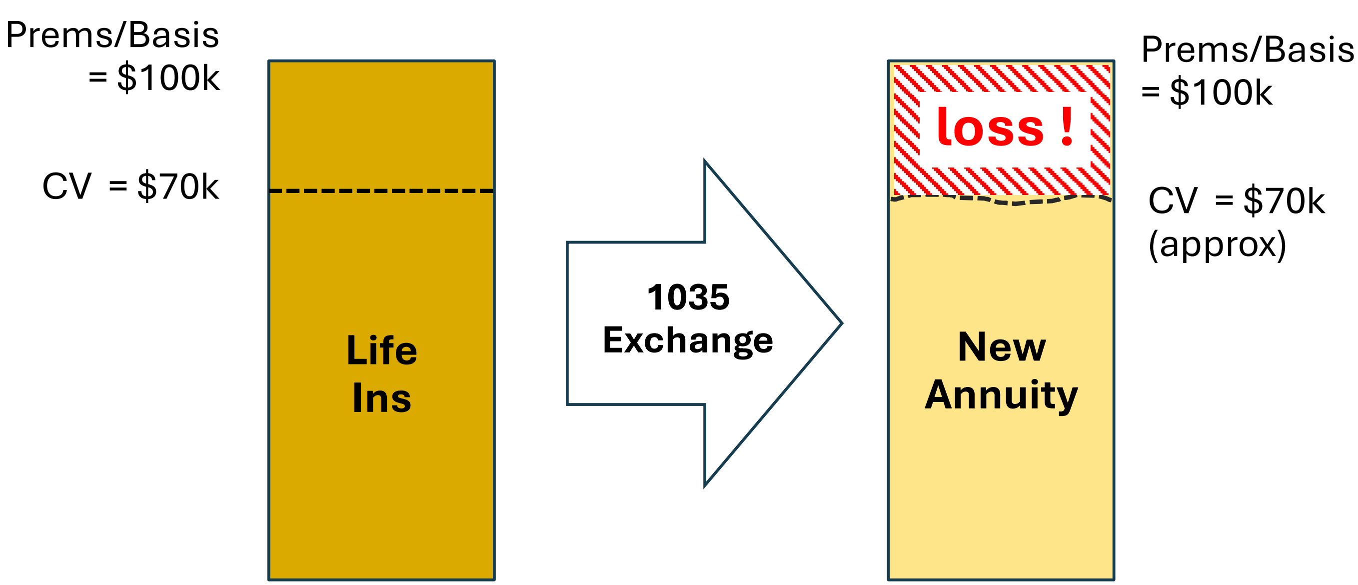
1035'ing policy that has no gain (underwater) … to annuity, and deduct loss



If the new contract is a deferred annuity, there's an argument the owner can surrender the new contract and **deduct loss on annuity.**

- Rev. Rul. 61-201; *Cohan v. Comm'r,* 11 B.T.A. 743 (1928).
- BUT see *Early v. Atkinson*, 175 F. 2d 118 (4th Cir. 1949).

Authorities have reached differing conclusions regarding deductibility. The appropriate treatment depends on the taxpayer's circumstances and should be evaluated with the taxpayer's tax advisor

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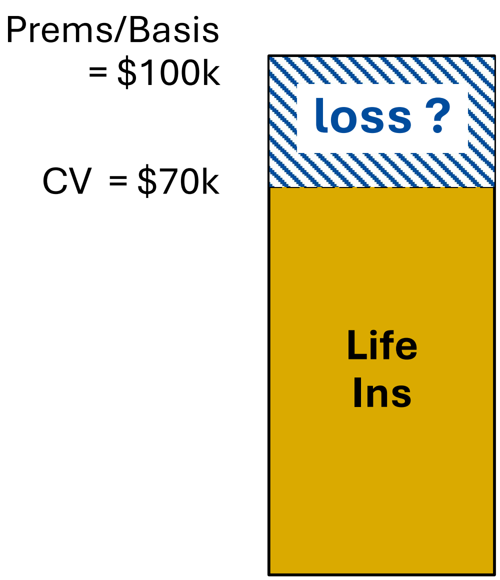
Are losses on life insurance deductible?



- Could owner have surrendered the life insurance and **deduct the loss on the life insurance?**

- Most say losses on life insurance are **never deductible**. See old cases:
  - *London Shoe Co., Inc. v. Comm'r.*, 80 F.2d 230 (2d Cir. 1935)
  - *Century Wood Preserving Co. v. Comm'r.*, 69 F.2d 967 (3d Cir. 1934)

- But **see Rev Rul 2020-5:**
  - <u>Maybe</u>* can deduct loss if policy was purchased –
    - in a trade or business (IRC §165(c)(1)) or
    - as part of a transaction entered into for profit (IRC §165(c)(2))
  - Also see *Cohen v. Comm'r.*, 44 B.T.A. 709 (1941); and *Fleming*, PH TCM P 45095 (1945).

*Certain authorities have been cited as support for loss deductibility in limited circumstances. Tax treatment is highly dependent on specific facts and circumstances.

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Quick aside about <u>term</u> <u>policies</u> after Rev. Rul. 2020-5

2017 Tax Cuts and Jobs Act amended IRC § 1016(a), making clear that a life contract's basis is simply the premiums paid, and is **not reduced by "cost of insurance,"** negating that part of Rev. Rul. 2009-13.

Revenue Ruling 2020-5 interpreted IRC § 1016(a) and made clear that **term policies have a basis** equal to cumulative premiums paid.

Gives rise to questions:

- If you had paid into a term life policy for many years, and then convert to a permanent policy, can you add the past cumulative term premiums to the policy's basis (in addition to whatever you paid to convert the policy)?
- Can you 1035 from a term policy? What if part of multiple policies being 1035'd into one permanent policy? Can you add the past cumulative premiums paid for that term policy into the basis of the resulting policy?

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partial exchanges and partial annuitizations

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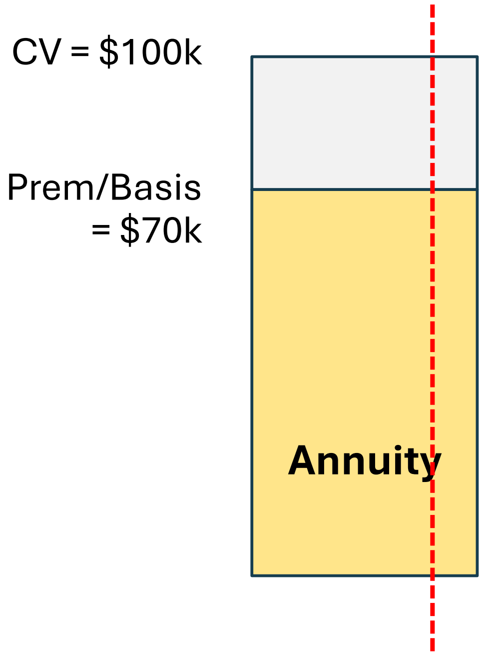
Partial exchanges and partial annuitizations (especially from annuities)



- Withdrawals from deferred annuities are normally taxed as gain-first.
- Consider annuity with $70k basis and $100k cash value ($30K of gain).
- Withdraw of $20k would normally be all taxable gain.
- What if **partially exchange** just 20% of contract (here, $20k) to another deferred annuity?
- New contract would have $14k basis and $6k gain.
- Can owner soon after surrender new contract, receive $20k, but be taxed on just $6k?

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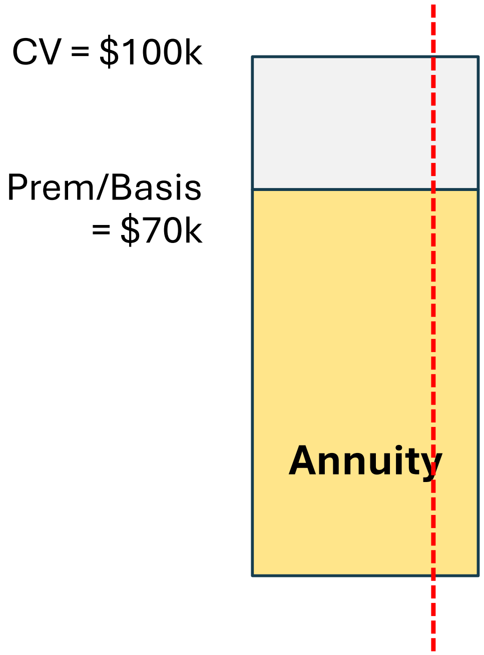
Partial exchanges



- Partial exchange of annuity is ok (pro-rata basis and gain).
  - *Conway v. Comm'r*, 111 T.C. 350 (1998).
  - Rev. Rul. 2003-76.
- To prevent perceived abuse that a partial exchange – followed by withdrawal from one of resulting contracts – was an unfair way to avoid normal gain-first taxation applicable to deferred annuities, IRS made a few pronouncements:
  - Notice 2003-51: If partial exchange, then pull money from either contract in next **24 months**, treated as coming from initial contract gain-first.
  - Rev Proc. 2008-24: If partial exchange, then pull money from either contract in next **12 months**, treated as coming from initial contract gain-first.
  - Rev. Proc. 2011-38. If partial exchange, then pull money from either contract in next **180 days (6 months)**, then **might** be treated as coming from initial contract gain-first, or as "boot."

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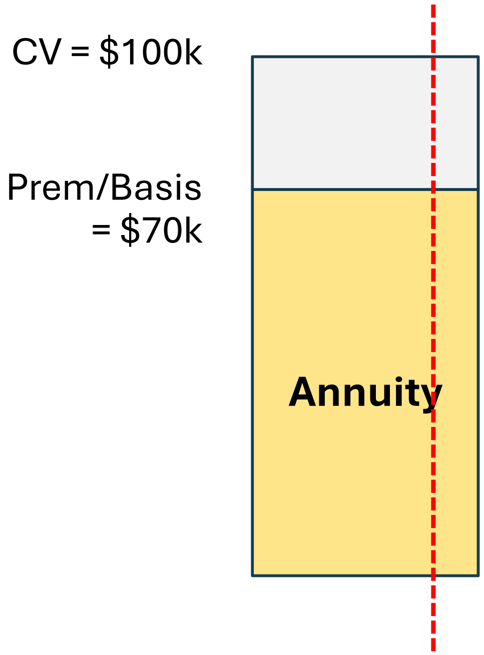
Partial annuitizations … since 2010



Small Business Jobs Act of 2010 created IRC § 72(a)(2)

- Partial annuitization enjoys pro-rata basis and gain treatment only if the annuitized portion:
  - endures for at least 10 years, or
  - is for the life.
- If partially annuitize for shorter period, is taxed as withdrawal from the original contract (gain-first if a deferred annuity).

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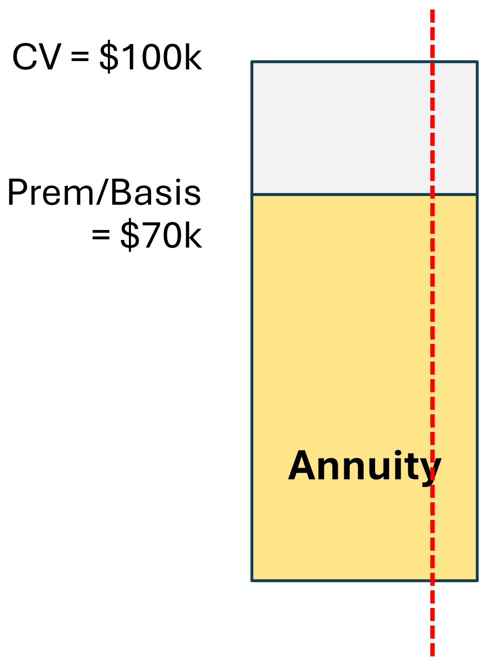
Partial exchanges into long-term care (LTC) insurance



- Notice 2011-68: Permits tax-free partial 1035s from life insurance or annuity contract into an LTC contract (to pay LTC premiums).
- If annuity payments from **partial annuitization** are 1035'd to pay LTC premiums, presumably not subject to IRC § 72(a)(2) (again, partial annuitizations taxed "as an annuity" only if for at least 10 years, or for life), as 1035'd amounts are not "received."

- Some insurers don't allow partial 1035s (or even splitting a policy).
- **Question**: What does your insurance company permit?

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post-death 1035s of nonqualified annuities

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Post-death 1035 of nonqualified annuity

- IRC § 72(s) requires distributions from annuity after death of holder / owner.
  - These rules still permit spreading payments over life of human beneficiary.
  - Nonqualified annuities not affected by Secure Act, which shortened post-death RMDs from IRAs to 10 years in most situations.

- Reasons why post-death beneficiary might want to carry out a 1035 exchange:
  - Fixed vs. Variable.
  - Stretch vs. Annuitization.
  - Payable to trust.

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Post-death 1035 of nonqualified annuity *(cont'd)*

- IRS has ruled that post-death beneficiary – as obligee – can carry out a 1035 exchange.
  - PLR 201330016.
  - PLR 200323012.

- After the 1035, the new contract is still subject to the post-death RMD rules of IRC § 72(s).

- Post-death 1035 is possible planning technique for trustee that is beneficiary of annuity contract that has "unfriendly" features.

- QUESTION: Does your insurance company permit "looking through" a trust to determine post-death annuity RMDs?

- QUESTION: Does your insurance company permit post-death 1035s? (incoming or outgoing)?

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let’s look at issues that are NOT particularly 1035-related

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Parent is insured . . .

One adult child is policyowner . . .

All children are co-beneficiaries

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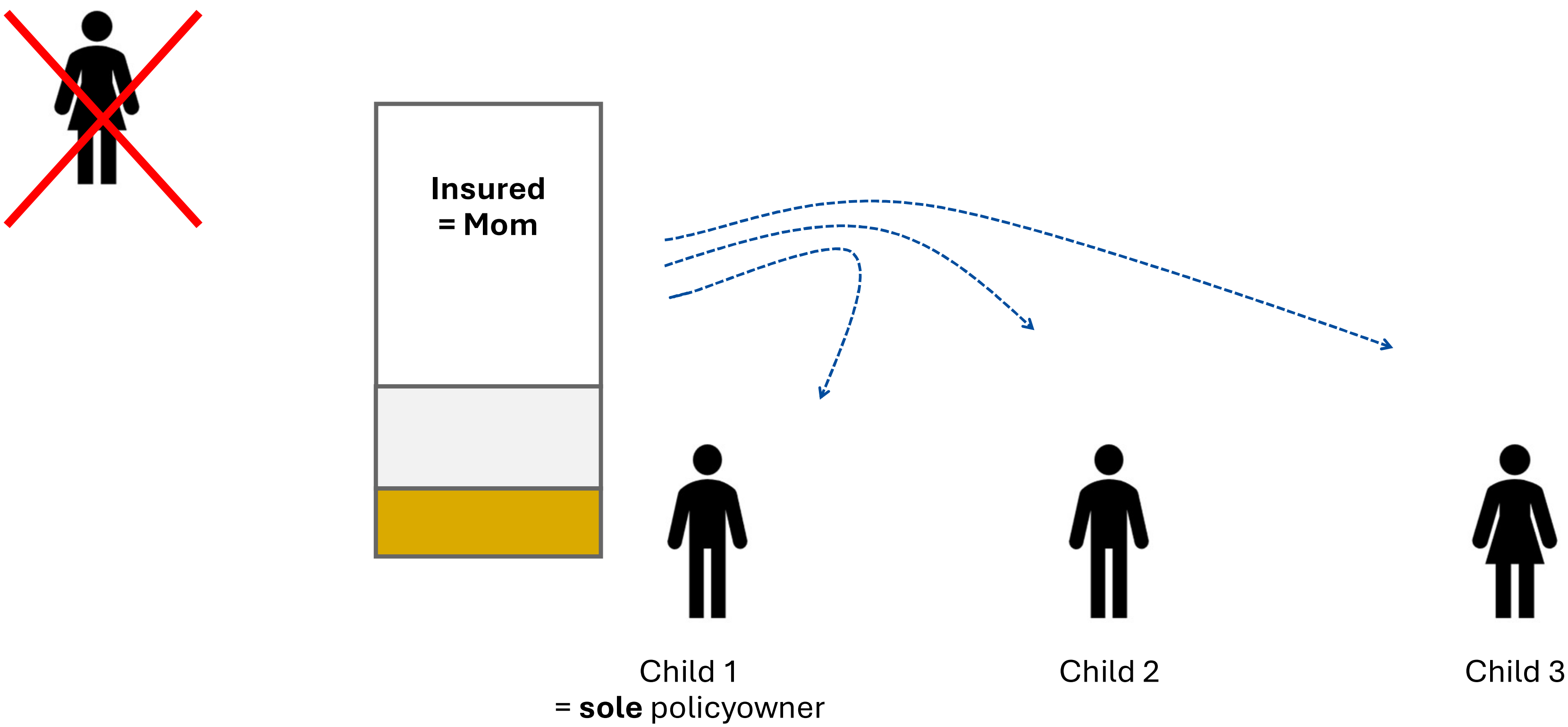
One adult child owns insuring parent … self and siblings are co-beneficiaries



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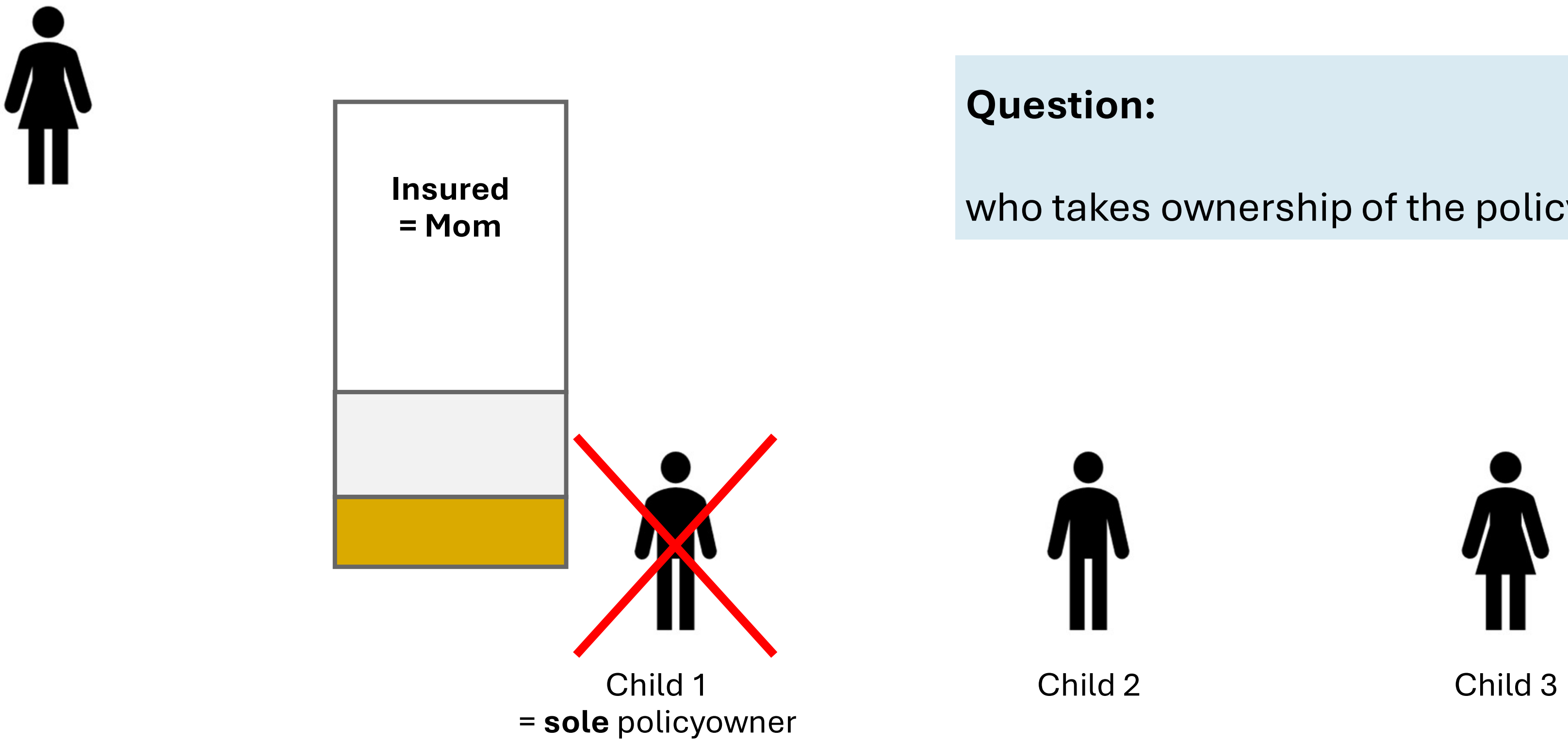
Or what if policyowner (non-insured) dies first?



Question:

who takes ownership of the policy?

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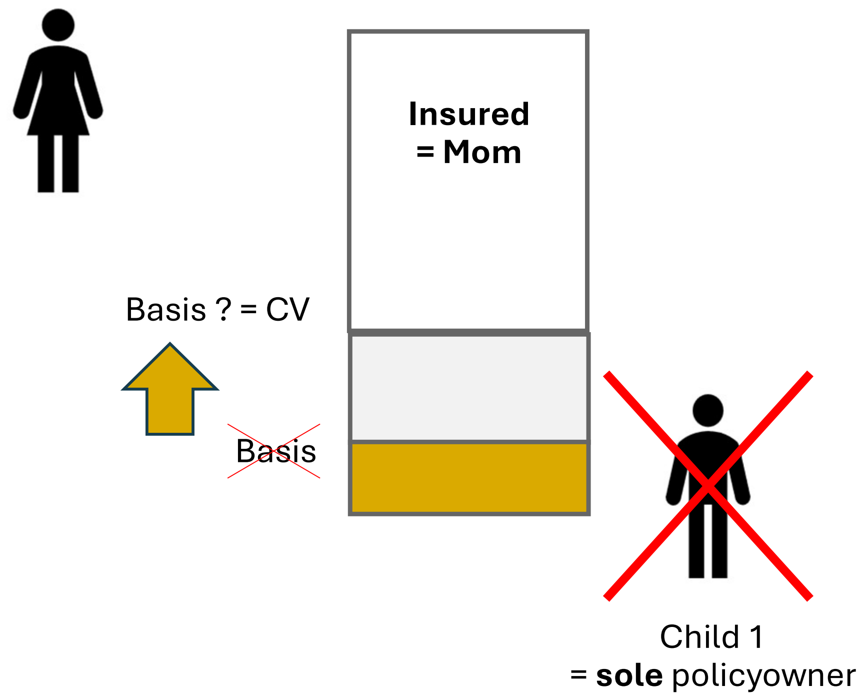
Step up in basis at death?



Question:

Regardless of who becomes the new owner, do life insurance policies enjoy a “step up” in basis at death?

There is uncertainty regarding treatment in certain circumstances, and no conclusion should be drawn without consultation with tax counsel.

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Two or more non-insured policyowners . . .

and **one** owner dies . . .

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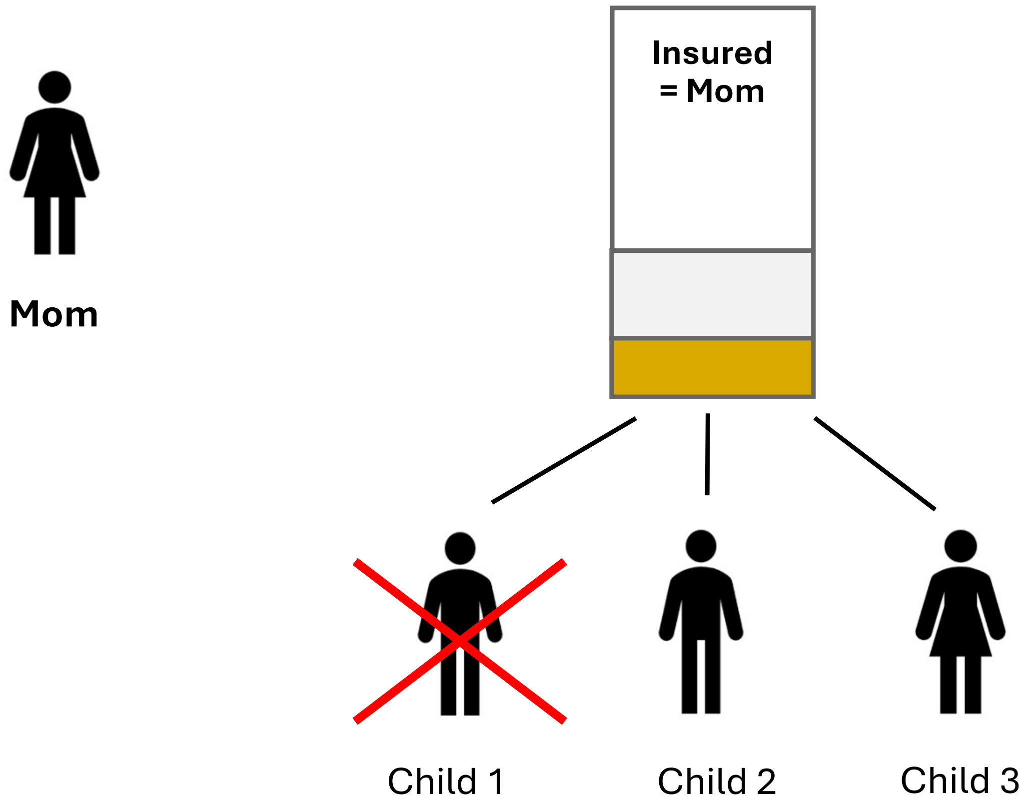
Two or more non-insured policyowners … and one owner dies



Question:

What happens to deceased co-owner's interest in policy?

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Divorce . . .

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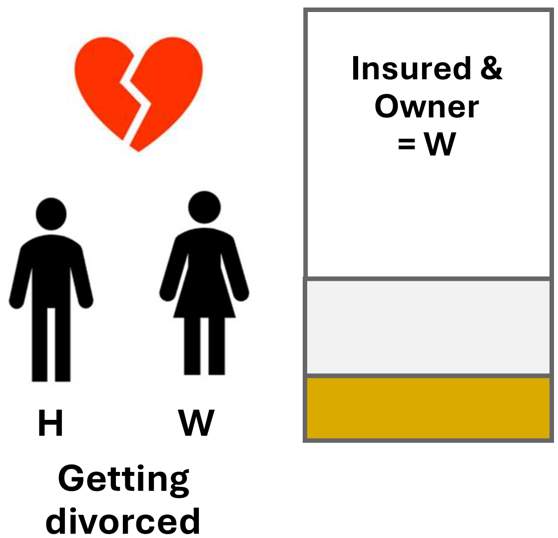
Divorce … effect on beneficiary designations in favor of (ex)spouse



Question:

Does W’s beneficiary designation of “my spouse” or even “John Smith” stay intact AFTER the divorce?

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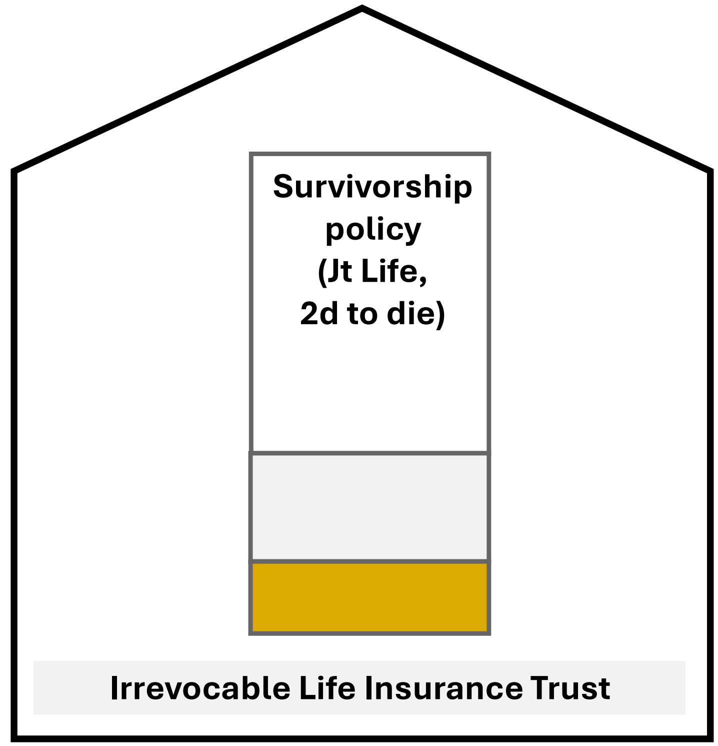
Divorce when survivorship policy is in ILIT

H W

Getting divorced



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when a beneficiary is a minor

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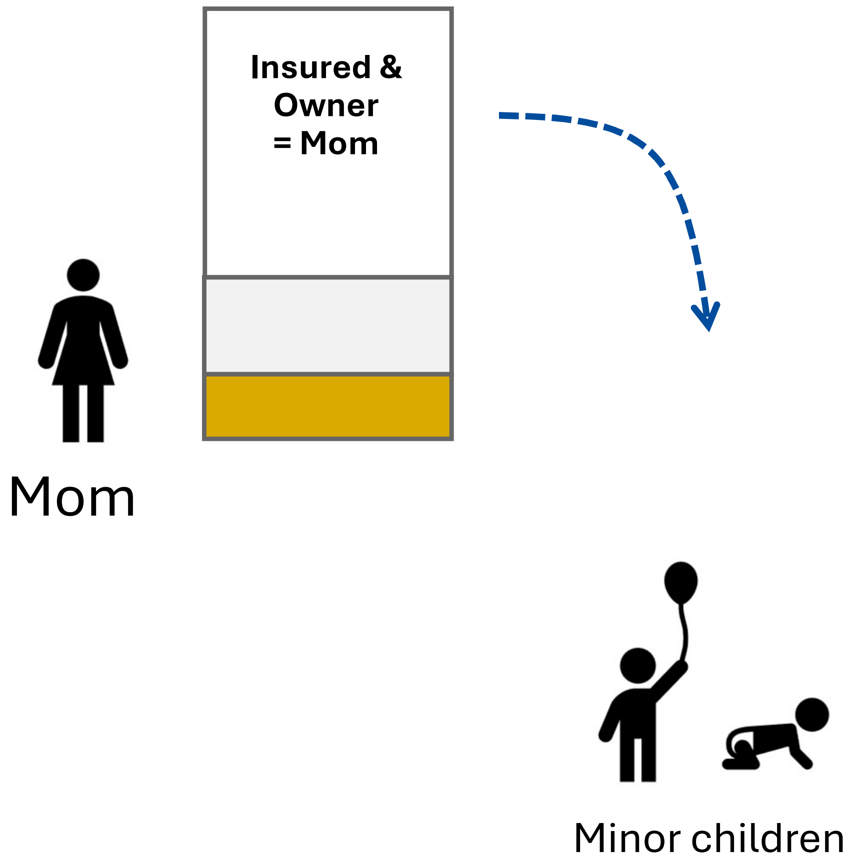
What if named beneficiary is a minor?



Problem:

Minors generally cannot receive death benefit.

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naming "my children" as beneficiary

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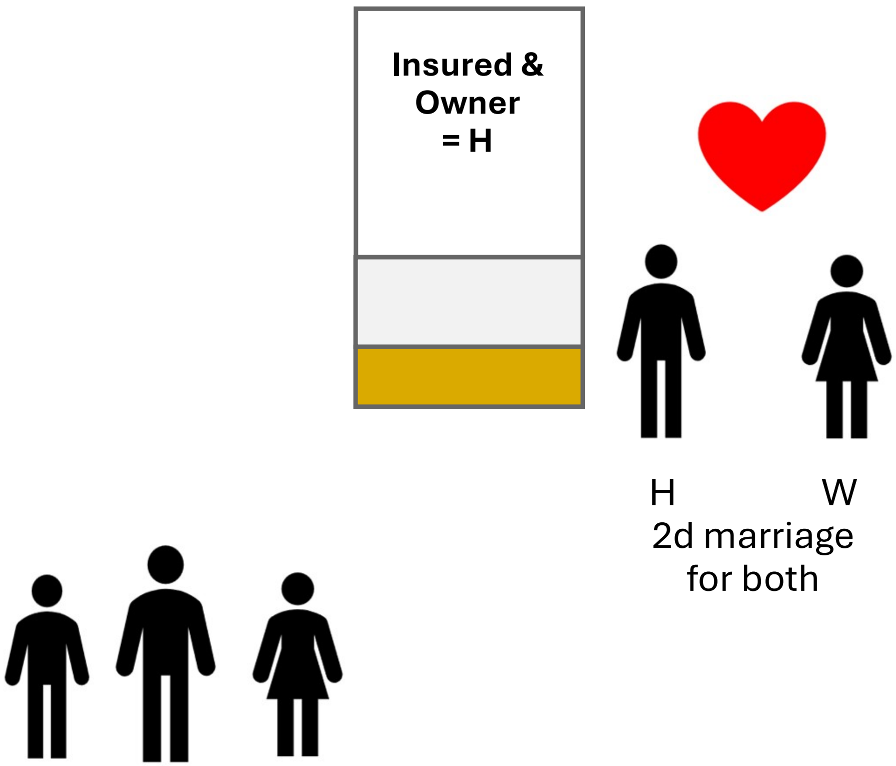
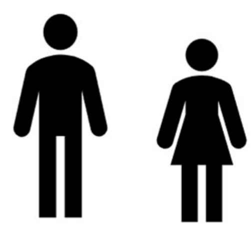
Beneficiary designation by H: “my children”



Question:

Does H’s beneficiary designation of simply, “my children,” include **<u>step</u>**children?



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Questions ?

Comments ?

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