

Section 1035 Exchanges

What is a 1035 exchange and how can it benefit clients?

A 1035 exchange is an exchange of a (non-qualified) life insurance policy, endowment contract, or annuity contract for another contract where the exchange meets the requirements of Internal Revenue Code (IRC) §1035. Normally, gain is immediately recognized on the surrender or exchange of a life insurance or annuity contract. However, Section 1035 provides that, in some instances, the policy or contract owner may make certain exchanges without the immediate recognition of gain. The income tax consequences are deferred or postponed.

Why would a client want to exchange an insurance policy?

A number of reasons could make a client want to exchange an existing policy for a new policy:

- ▶ Many new types of insurance products (as well as riders) that were not available a few years ago are available today.
- ▶ As a client's family, business, and financial status change, objectives may change, and the insurance purchased to meet those objectives may also need to be changed.
- ▶ In some cases, a new type of policy can solve a client's need for insurance in a more cost-effective manner.
- ▶ There may be a concern that the present insurer may become insolvent.

Where one or more of these factors exist, clients should be made aware of the opportunity and given a chance to exchange the old policy for a new policy under IRC §1035.

Client's best interest. Not every policy exchange will be in the best interest of the client. The replacement of one policy with another must be considered carefully. In addition to the tax factors, which are the primary focus of this FAQ, a number of non-tax factors should be considered before suggesting an exchange:

- ▶ New acquisition costs
- ▶ Possible surrender penalties
- ▶ The insurability of the client

Additionally, clients should be made aware that there are important protections in an old policy (e.g., incontestable clause and suicide clause) that are not immediately present in a new policy.

In other words, financial professionals should suggest or recommend the exchange of an existing life insurance policy or annuity contract for another life insurance policy or annuity only when it is in the best interest of the client.

Can a 1035 exchange be made from an IRA to another IRA or from a qualified plan to another qualified plan?

Section 1035 of the Internal Revenue Code relates only to the exchange of non-qualified contracts. IRAs and qualified retirement plans are not covered by Section 1035. Of course, clients can move assets from one IRA or qualified plan to another, but those transactions are not covered under Section 1035.

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What types of tax-deferred exchanges are allowed under IRC Section 1035?

Section 1035 provides that only certain types of exchanges may be made without the immediate recognition of gain. Taxpayers are permitted the following types of exchanges:

- ▶ A life insurance policy for another life insurance policy, an endowment contract, an annuity, or a qualified long-term care insurance contract.
- ▶ An endowment contract for another endowment contract, an annuity, or a qualified long-term care insurance contract.
- ▶ An annuity contract for another annuity contract or a qualified long-term care insurance contract.
- ▶ A qualified long-term care insurance contract can be exchanged for another qualified long-term care insurance contract.

Both a life insurance policy and an annuity contract provide for tax deferral. But a life insurance policy provides more tax advantages because it provides death proceeds that are generally income tax-free under IRC §101(a). In a 1035 exchange, tax advantages can be given up, but they can't be increased. So it is possible to make an exchange of a life insurance policy for an annuity, but it is not possible to 1035 exchange an annuity for a life insurance policy.

Must there be a gain in the policy to do a 1035 exchange? Why would a client want to exchange a policy that does not have a gain?

No. A 1035 exchange can be done even if the policy value is less than the investment in the contract.

While a 1035 exchange of a policy in a "loss" position does not provide a current tax-deferral benefit, it does allow the client to carry over his or her cost basis to the new policy. This would reduce the amount of taxable gain in the new policy or contract when the client takes distributions.

What is the cost basis in the new policy or contract?

When a client exchanges policies or contracts as part of a 1035 exchange, the cost basis in the new policy or contract is the same as the cost basis was in the old policy or contract, increased by any taxable gain recognized on the exchange, and then decreased by the amount of boot received (cash, cancellation of loan). The definition of boot is discussed later.

Must the owner and insured or annuitant be the same both before and after the exchange?

Yes. To have a valid 1035 exchange, the owner and insured or annuitant combinations on the old and new contracts must be the same. There are no exceptions. It should be noted, however, that if the old policy insures a spouse or children under removable riders, the new policy could be issued without those riders and with the primary insured as the sole insured. While this would appear to be an exception, in reality, this just recognizes that, contractually, the riders could be removed from the old policy without it being considered a surrender, and then an exchange can be made.

Can multiple contracts be consolidated into one contract through a 1035 exchange? Must the consolidation be into a new policy or can it be into an existing policy?

Clients are permitted to exchange one or more contracts for a new contract and still have the 1035 exchange be valid. For life insurance policies, this consolidation must occur at the time the new policy is issued.

Historically, a valid 1035 exchange could not be made into an existing contract. These rules still govern life insurance policies. However, there have been some changes in interpretations regarding the annuity market.

Late in 2002, the IRS issued Revenue Ruling 2002-75, in which it indicated that the exchange of one annuity contract into an existing annuity contract would be permissible. In effect, this allows for consolidation of assets. This ruling was limited in discussion to annuity contracts. Therefore, Prudential allows exchanges into existing annuity contracts, but not into existing life insurance policies.

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Can two single life policies, each insuring different lives, be exchanged for one second-to-die policy on both lives? Can a second-to-die policy be exchanged for two single life policies?

The IRS has ruled that exchanging two separate life policies for one second-to-die policy does not qualify as a valid 1035 exchange. However, if an individual has a second-to-die policy and one of the insureds is already deceased, the policy has only one insured. An exchange from a second-to-die policy to a single life policy under this circumstance is permitted.

Can a client exchange a term insurance policy for a permanent insurance policy?

Prudential does NOT allow exchanges of term policies. We require \$1,000 minimum cash surrender value on all 1035 exchanges, and “reserve” values are not available on surrender.

NOTE: Term insurance contracts can be exchanged under Section 1035 as long as they have a terminal reserve at the end of the first year. Term contracts with a terminal reserve will generally have a level premium and a level death benefit for a period of more than one year. An exchange from a term insurance policy to an annuity contract does not require a minimum cash surrender value; however, any annuity contract issued as part of the exchange would have to meet product minimum values. This would typically require the contract owner to contribute additional cash to the transaction to bring the new contract up to the minimum required value.

When can a client exchange an endowment contract? Can they wait until the policy matures and get the higher maturity dividend?

An active policy or endowment contract can be 1035 exchanged for another endowment contract (as long as certain requirements are met), an annuity contract, or a qualified long-term care insurance policy. An endowment contract cannot be exchanged for a life insurance policy. Once a contract matures, it is no longer an active contract and cannot be used for a 1035 exchange. If a client wants to continue the deferral on the inside gain, then the exchange must occur before the contract matures. Once a contract matures, a 1035 exchange to another contract cannot be done. In contrast, if a client wants to make an exchange to an immediate annuity, this can be accomplished by letting the policy mature and then electing a settlement option under IRC §72(h).

Does the exercise of a policy exchange rider by a business qualify as a 1035 exchange?

No. A policy exchange rider is an option in a life insurance policy permitting an employer to change the insured from one person to another. The benefit of this option is that no new acquisition costs are incurred. The IRS has ruled that this transaction cannot qualify for a deferral of taxation under Section 1035 because the insureds under the old and new contracts are not the same. Consequently, an exchange pursuant to such a policy rider is a taxable disposition of the policy, rather than a tax-deferred exchange.

What is *boot*, and how does it apply to 1035 exchanges?

Boot is generally defined as any value from an old contract that is not transferred to a new contract. Boot is taxable to the client to the extent that there was gain in the old contract. Boot in a 1035 transaction includes:

- ▶ Any outstanding loans that are not repaid and are not mirrored in the new contract.
- ▶ Any cash value from the old contract that is returned to the client.

Withdrawals taken shortly before the exchange may be considered taxable as “boot.” Clients should contact a tax advisor before initiating the exchange to determine if withdrawals will be taxable as boot.

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What happens if the existing contract has an outstanding loan? What are the options?

Financial services professionals must be especially careful when a policy exchange involves a policy with a loan against it. If the debt is not mirrored (carried over) in the new policy, its release will be treated as boot, taxable to the extent of gain in the contract. There are three options for addressing this issue. Each option has its advantages and disadvantages:

Options	Advantages	Disadvantages
Pay the loan with out-of-pocket money.	The client incurs no tax on the gain when the old policy is exchanged for a new policy.	The client may not be able to afford the out-of-pocket payment to pay off the loan. Note: There is nothing preventing the client from paying off the loan, doing the exchange, and then borrowing from the new policy (assuming the new policy is not a MEC).
Do nothing and allow the loan to be canceled.	The client incurs no out-of-pocket payments at the time of the exchange.	The client's loan will be reported to the IRS as taxable to the extent of gain in the contract.
Mirror (carry over) the loan in the new policy.	By carrying over the loan to the new contract, the client incurs no gain when the old policy is exchanged for the new policy with the mirrored loan. Note: Mirrored loans are not allowed on life-to-annuity exchanges, since none of our annuity products allow loans.	Prudential permits mirrored loans; however, we reserve the right to refuse any mirrored loan request. ALL mirrored loan requests require advance Corporate approval. In addition, mirrored loans may increase the likelihood that the new policy will become a MEC if large additional premiums are required.

Are partial exchanges allowed from life insurance policies? Are partial exchanges allowed from annuity contracts?

Partial exchanges are not allowed from life insurance policies. Any 1035 exchange from a life insurance policy must be for the full value of the life insurance policy. Historically, the 1035 exchange of an annuity contract required the exchange of an entire contract for a new contract. Anything not transferred was considered a taxable distribution. However, in 1998, in *Conway v. Comm.*, 111 TC 350, the Tax Court held that a valid 1035 exchange occurs where a contract owner transferred a portion of the funds in one annuity contract to a second newly issued contract. Subsequent to the Conway decision, the IRS issued Revenue Ruling 2003-76 and Notice 2003-51, providing interim guidance on partial exchanges of annuity contracts. Specifically, the notice states that, to determine the tax treatment, the IRS will consider all the facts and circumstances to determine whether a partial exchange followed by a distribution from, or surrender of, either the surviving annuity contract or the new annuity contract within 24 months of the date on which the partial exchange was completed should be treated as an integrated transaction and the two contracts viewed as a single contract.

However, if a taxpayer demonstrates that one of the conditions of IRC §72(q)(2) (relating to exceptions to the imposition of penalty tax) occurred between the partial exchange and the surrender or distribution and the surrender or distribution was not contemplated at the time of the partial exchange, the taxpayer would not be treated as having entered into the surrender or distribution for tax avoidance purposes. The rulings also provide that cost basis will be allocated on a pro rata basis between the old and new contracts.

In 2008 the IRS and Treasury issued Rev. Proc. 2008-24, shortening the 24-month period to 12 months and eliminating the subjective requirement that certain distributions or surrenders were not contemplated at the time of the exchange. There has been no indication that partial exchange treatment will be extended beyond annuity contracts to life insurance policies.

In 2011 the Treasury issued Rev. Proc. 2011-38, shortening the 12-month period to six months. The implications as to whether a distribution within six months will destroy the partial 1035 exchange treatment will now be evaluated by the IRS on a case-by-case basis. There has been no indication that partial exchange treatment will be extended beyond annuity contracts to life insurance policies.

Will a client receive any tax forms in a 1035 exchange?

Generally, 1035 exchanges are not taxable. For an outgoing 1035 exchange, a client will receive Form 1099-R with a code 6 in box 7, and a 0.00 (zero) taxable amount. This identifies the transaction as a 1035 exchange to the IRS. A second Form 1099-R will be issued if there is boot, showing the amount of taxable gain related to the boot.

If a 1035 exchange is a “tax-free exchange,” why are premium taxes charged against incoming 1035 proceeds from other carriers?

A 1035 exchange is a tax-free exchange from an individual's income tax perspective. However, the insurer is still required to pay a tax on any premiums received, regardless of whether the money used to pay those premiums is from the client's pocket or 1035 proceeds from the old contract. As a result, premium taxes are deducted from any 1035 proceeds applied to the new contract.

Can a contract owner exercise the free-look provision and reinstate the original contract after a 1035 exchange?

If the old contract has already been surrendered, then the client will not get the old contract back.

What happens if an old annuity contract has pre-TEFRA (Tax Equity & Fiscal Responsibility Act of 1982) money in it?

The new annuity contract retains the characteristics of the old contract. There is an ordering rule for the money coming out:

1. Pre-TEFRA contributions.
2. Pre-TEFRA earnings.
3. Post-TEFRA earnings.
4. Post-TEFRA contributions.

If the old policy was “grandfathered” and exchanged for a new life insurance policy, will the new policy be “grandfathered”?

No. Pieces of legislation significantly impact the tax treatment of life insurance policies. The Deficit Reduction Act of 1984 extended the definition of life insurance to all life insurance policies issued after that date. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) led to the implementation of the seven-pay test to determine if a policy is a modified endowment contract (MEC). Both pieces of legislation include provisions that grandfathered existing policies—meaning, existing policies were not subject to the new laws as long as changes were not made to the policy. A policy's grandfathered status is lost if it is exchanged for a new policy issued after the effective date, even if it is issued as part of a 1035 exchange.

If a client has a life insurance policy with values less than the policy's cost basis, can they exchange the policy for an annuity under Section 1035 and then surrender the annuity and claim a loss?

- ▶ When the life insurance policy is surrendered, a client gives up death benefit protection that they may need.
- ▶ Prior to the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, a loss on an annuity could be recognized as a miscellaneous itemized deduction subject to the “2% rule” under Section 67 of the Code. The TCJA suspended deductions under Section 67. Therefore, losses on annuity contracts may no longer be recognized.
- ▶ Even prior to this legislation, using an annuity contract to create an opportunity to recognize a loss on a life insurance policy was extremely problematic and required significant consultation with a qualified tax advisor.
- ▶ The suspension of Section 67 miscellaneous deductions will expire on Dec. 31, 2025.

What can be done to ensure that a policy exchange is processed as a 1035 exchange?

The exchange of one policy for another policy can be a time-consuming and complex process. The typical exchange involves the following steps:

1. An Absolute Assignment Form (ORD 88649) must be completed, transferring all rights in the old policy to the insurer that will issue the new policy. The form must be signed and dated by the current owner.

Important: Owners must be the same on both policies. All information must be legible. Any crossed-out or inserted information must be initialed by the owner.

2. The new business application must indicate the contract is part of a 1035 exchange. The policy number(s) of the policy(ies) that will be surrendered should be documented.
3. The original copy of the policy should be attached to the forms. If the replaced policy is not attached to the request, a Lost Policy Declaration (COMB 124) must be completed or, in lieu of the policy declaration, a written statement from the client must be provided. Include estimated cash value and any outstanding loan balances of the other company's contract.
4. For The Prudential Insurance Company of America (Prudential), the normal minimum cash value for incoming 1035s on a life insurance policy is \$1,000. Lower amounts require advanced underwriting approval.
Important: Make sure you complete and submit the appropriate replacement forms, which can vary by state.
5. A new policy is issued to the policyowner before the company issuing the new policy surrenders the old policy. During this time period the client should be encouraged to continue paying any required premiums to keep the existing policy in force until the client accepts the new policy. A client will avoid a lapse and a break in insurance coverage if they decides to reject the Prudential policy.
6. The old policy is then surrendered.

Summary

Exchanges of older policies for new policies have become very popular. It is important that the exchange is structured to qualify for tax-free treatment under Section 1035. If that isn't done, the surrender proceeds from the older policy will constitute ordinary income to the extent they exceed the policyowner's basis.

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