



What is a 1035 Exchange?

Why would a client want to exchange an insurance policy?

There are a number of reasons why a client might want to exchange an existing policy for a new policy. Today there are many new types of insurance products available that were not available a few years ago. Furthermore, as a client's family, business and financial status change, the insurance purchased to meet those objectives may 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 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 Section 1035.

However, not every policy exchange will be in the best interest of the client. The replacement of one policy for another must be considered carefully. In addition to the tax factors, which are the primary focus of this FAQ, there are a number of non-tax factors that should be considered before suggesting an exchange. The non-tax factors that should be considered include: (1) new acquisition costs (2) possible surrender penalties and (3) 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.

Bottom line sales professionals should suggest or recommend that an existing life insurance policy or annuity contract from any company be

replaced or the purchase of life insurance or any annuity be financed from another life insurance or annuity contract, only when it is in the best interest of the client.

So what is a 1035 exchange and how does it benefit my clients?

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

Can I do a 1035 exchange from an IRA or other qualified plan to another contract?

Section 1035 of the Internal Revenue Code relates only to exchange of nonqualified contracts, ones that do not receive qualified retirement plan treatment. Of course, clients can exchange qualified assets for other qualified assets, but that is not covered under Section 1035.

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:

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Prudential  **Financial**

- Life insurance policy for another life insurance policy, endowment contract or annuity
- Endowment contract for another endowment contract or annuity
- Annuity contract for another annuity contract

Think of it this way. Both a life insurance policy and an annuity contract provide for tax deferral. But, a life insurance policy has a greater tax advantage in that the payout in the form of death proceeds is generally income tax-free under IRC § 101(a). You can give up tax advantage in a 1035 exchange, but you cannot increase your tax advantage. Hence you can go from life to annuity, but not annuity to life.

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. You can do a 1035 exchange 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/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 you received (cash, cancellation of loan). The definition of boot is discussed later.

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

Yes. In order to have a valid 1035 exchange, the owner and insured/annuitant combinations on the old and new contracts must be the same.

There are no exceptions.

We would note, however, that if the old policy insures a spouse or children under removable riders, the new policy can be issued with the primary insured as the sole insured. While this could appear to be an exception, in reality, this just recognizes that you were contractually able to remove the riders from the old policy without it being considered a surrender. You could then do an exchange. This allows you to consolidate the steps.

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 this considered a valid 1035 exchange. For life insurance policies, this consolidation must occur at the time the new policy is issued.

Historically, there also had to be a new contract issued in exchange for the old contract. 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 over the past couple of years.

Late in 2002, the IRS issued Revenue Ruling 2002-75 in which they indicated that you could exchange one annuity contract into an existing annuity contract. In effect, allowing for consolidation of assets. This ruling was limited in discussion to annuity contracts. Hence, Prudential allows exchanges into existing

annuity contracts, but not into existing life insurance policies.

Can I exchange two single life policies, one on each of two lives for one second-to-die policy on both lives? Can I exchange a second-to-die policy for single life policies?

Going from two separate policies, each one covering one life, to a second-to-die policy on both lives would not provide the same owner/insured requirement both before and after when viewing each of the original policies. Thus, the Service has ruled that this arrangement of surrendering two separate life policies for one second-to-die policy would not qualify as a valid 1035 exchange.

Where a client has a second-to-die policy, and one of the insureds is already deceased, the policy effectively has only one insured when considering 1035 exchanges. 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 whole life insurance policy?

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.

Why would a client want to exchange a term insurance policy for a whole life insurance policy if the term policy has no cash value?

While a 1035 exchange from a term policy would not provide any cash value in the new contract, what it allows the client to do is carry over his/her cost basis in the term contract. This would reduce the amount of taxable gain in the new policy or contract when the client takes distributions from the new permanent policy.

(See Prudential Financial's Frequently Asked Questions IFS-A070264: *What is a Term Policy's Basis in an IRC § 1035 Exchange*)

When can a client exchange out of an endowment contract? Can he/she wait until the policy matures and get the higher maturity dividend?

In order to qualify for exchange treatment under Section 1035 of the Internal Revenue Code, the client must have an active policy or contract. Once a contract matures, it is no longer an active contract and cannot be used for a 1035 exchange.

If a client is looking to continue the deferral on the inside gain, then he/she needs to make the exchange before the contract matures and take the lower termination dividend. Once that contract matures, a 1035 exchange cannot be done to another contract with Prudential or any other carrier.

In contrast, if your client wants to exchange to an immediate annuity to set up payments, he/she can accomplish this by letting the policy mature and then elect a settlement option under IRC § 72(h). For our own administrative purposes, we often do that by moving the proceeds into a different product for the payout phase.

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 Service has ruled that this transaction cannot qualify for a deferral of taxation under Section 1035 because the insured under the old and new contract 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.

Are partial exchanges allowed?

Originally, a 1035 exchange required an exchange of an entire contract for a new contract. Anything not transferred over was considered a taxable distribution. However, in 1998, in *Conway v. Comm.*, 111 TC 350, the Tax Court held that a valid 1035 exchange occurred 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 Service issued Revenue Ruling 2003-76 and Notice 2003-51 allowing partial exchanges of annuity contracts. The rulings also provide that cost basis will be allocated on a pro rata basis between the old and new contracts. The Service and Treasury further indicated that they will be reviewing transactions and looking at possible regulations prescribing the tax treatment of certain partial exchanges that may be entered into to avoid taxes. Mentioned in particular as a focus are transactions where there is a withdrawal or surrender from either the original or the new contract within 24 months of the partial exchange. There has been no indication that partial exchange treatment will be extended beyond annuity contracts to life insurance policies.

I've heard the term "boot" with regard to 1035 exchanges. What is boot?

Boot is generally defined as any value from the old contract that is not transferred to the new contract. Boot in a 1035 transaction includes: 1) Any outstanding loans that are not repaid and are not mirrored in the new contract; and/or 2) Any cash value from the old contract that is returned to the client. Boot is taxable to the client to the extent that there was gain in the old contract.

What happens if the existing contract has an outstanding loan? What are my client's options?

Financial service 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. Each option has its advantages and disadvantages.

Options	Advantages	Disadvantages
Pay the loan with out-of-pocket money	The client incurs no tax 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. 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 cancelled	No out-of-pocket payments incurred by the client 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 the loan to the new contract, the client incurs no gain when the old policy is exchanged for the new policy with the	Prudential permits mirrored loans; however, we reserve the right to not accept the mirrored loan request. Generally they

	mirrored loan. Note: Mirrored loans are not allowed on life-to-annuity exchanges, since none of our annuity products allow loans.	are not allowed due to their complexity and expense. In addition, mirrored loans increase the likelihood that the new policy will become a MEC.
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Will my client receive any tax forms in a 1035 Exchange?

Generally, 1035 exchanges are not taxable. For an outgoing 1035 exchange (even if the exchange is between 2 companies within the Prudential family), your client will receive a Form 1099-R with a code 6 in box 7, and a 0.00 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, such as a cancellation of a loan, showing the amount of taxable gain related to the boot.

If a 1035 exchange is a “tax-free exchange”, why does the Company deduct premium tax charges from 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 are from the client’s pocket or 1035 proceeds from the old contract. As a result, the company deducts premium taxes from any 1035 proceeds applied to the new contract.

What happens if a contract owner exercises the free-look provision of the new contract after a 1035? Can they get back their old contract?

If the old contract has already been surrendered, then most likely the client cannot get back their old contract. If we processed the surrender of the old policy or contract in accordance with the client’s request, we generally would not be able to reverse the surrender of the contract.

For annuity contracts, what happens if the old 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” will the new life insurance policy be “grandfathered”?

Two pieces of legislation have significantly impacted 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 7-pay testing to determine if a policy was a modified endowment contract (MEC), which would receive less favorable tax treatment for pre-death distributions from the policy. Both pieces of legislation included 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 grandfather status is lost if exchanged for a new policy issued after the effective date, even if it is issued as part of a 1035 exchange.

Clients may have life insurance policies with values less than their cost basis. I’ve heard that one way to get a tax benefit on the loss

is to do a 1035 exchange into an annuity and then surrender the annuity. Does that work?

This has been bantered about as a possible way of recognizing losses from a variable policy, but this is not normally suggested as something to recommend to your clients for a number of reasons. First, in surrendering the life insurance policy, your client is giving up death benefit protection that he/she may need. Second, the surrender of the newly acquired annuity contract most likely will result in the imposition of surrender charges that could reduce or eliminate any tax benefit. Third, while it's true that losses from a life insurance policy are not deductible and losses from annuity contracts are allowable tax deductions, it's not clear whether the annuity losses are fully deductible against ordinary income or deductible as a miscellaneous deduction subject to a limitation of 2% of Adjusted Gross Income (AGI). If the loss is subject to the 2% floor the tax benefit your client can achieve under this strategy is significantly reduced. In addition to the 2% of AGI rule, a miscellaneous itemized deduction is subject to the phase-out of itemized deductions for taxpayers above certain income levels and is not allowed when computing the alternative minimum tax. Also, when computing the amount of loss upon the surrender of a variable annuity the amount of the surrender charge may not be considered. Finally, if the two transactions are viewed as a single integrated transaction, the Service could attempt to step the two pieces together and successfully disallow the losses as a tax deduction. Prudential clients should hesitate to put themselves into that costly and precipitous a situation.

What can I do 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:

- An Absolute Assignment form must be completed (ORD 88649) 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.
- The New Business application must indicate the contract is part of a 1035 Exchange. Make sure you document the policy number of the policy(ies) from the other carrier that will be surrendered.
- 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 must be completed (COMB 124) or a written statement from the client in lieu of the policy declaration. Include estimated cash value and any outstanding loan balances of the other company's contract. (For Prudential the minimum cash value for incoming 1035's must be \$5,000 and the minimum face amount \$50,000.) **Important:** Make sure you complete and submit the appropriate replacement forms.
- A new policy is issued to the policy owner before the company issuing the new policy surrenders the old policy. During this time period you should encourage your client to continue paying any required premiums to keep the existing policy in force until the client accepts the new policy. Your client will avoid a lapse and a break in insurance coverage should your client reject the Prudential policy.
- 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 or else the surrender proceeds from the older policy will constitute ordinary income to the extent they exceed the policy owner's basis.