1035 Exchanges and Policy Loans

It's a common situation: a person has a life insurance policy that was built for cash accumulation. He or she took a loan from the policy because the flexibility to do that is what attracted the client to that type of contract in the first place. Or maybe the client didn't take money out of the policy, but he or she stopped paying premiums for some reason, and automatic policy loans have accumulated. Many years later the client wants more death benefit, or new features, or lower ongoing premiums, or better underwriting, so he or she wants to move the remaining cash value of the old policy to a new one in a "1035 exchange." What happens to the loan? Will the exchange be truly tax free? Clients need to know before making a move.

Four basic tax rules apply to understanding the taxation of policy loans and 1035 exchanges for life insurance contracts that are *not* modified endowment contracts (MECs):

- Cancellation of debt generally is treated as taxable income.
- Withdrawals from a life insurance policy in excess of basis[1] are taxed as ordinary income.
- If a policy is exchanged for a new policy *and* something else of value, this "something else" is called "boot." The "boot" portion does *not* qualify for tax-free exchange treatment under Section 1035 of the Tax Code, resulting in the lesser of the gain on the old policy or the value of the "boot" being taxable.[2]
- If two or more transactions are planned together to have the same economic outcome but better tax treatment than a single transaction would have, the IRS can ignore the "steps" taken and apply tax as if there had been only that single transaction ("step transaction doctrine").

How NOT to Handle a 1035 Exchange of a Policy with a Loan

Let's apply these principles to a typical policy loan and 1035 exchange situation. Jane Doe has a policy that is 20 years old, which has scheduled premiums of $10,000 per year. In other words, she has paid $200,000 for the policy so far. The cash value of the policy is now $300,000, but several years ago she took out $100,000 loan against the policy for a down-payment on a new home. She has not been making principal or interest payments on this loan, so she now owes $140,000, and the net cash surrender value of her policy is $160,000.

Jane's children are now independent adults and she's nearing retirement. She would like to stop paying premiums and exchange the remaining cash surrender value for a single-premium policy with a lower death benefit and long term care rider. Can she do that without triggering a tax bill?

Exchanging a Policy Net of Loan	
Old policy cash value	$300,000
Old policy basis	$200,000
Gain on old policy (CV – basis)	$100,000
Value of loan ("boot")	$140,000
Taxable distribution (lesser of gain or "boot")	$100,000
Value applied to new policy premium	$160,000

If she simply exchanges the net cash surrender value, the issuer of the old policy will report her loan as not carried over to the new policy—and therefore taxable—on a Form R-1099, and only the net surrender value will be eligible for 1035 treatment. This chart shows how her taxable income would be calculated. Jane ends up having to recognize her entire gain on the policy, despite structuring it as a 1035 exchange. The basis of the new policy is calculated as old basis – boot + recognized income, equaling $160,000, the same as 1035 exchange value applied to the new policy. She ends up with the same tax bill as if she had surrendered the old policy and then purchased a new one with the cash proceeds.[3]

Paying Off Loans with Withdrawals to Basis

What if, instead of the above situation, Jane were to take a partial withdrawal of cash from her existing policy, and use it to pay off the loan before the exchange? Assuming that the withdrawal is less than her basis, she can take cash out of an *in-force* policy on a first-in, first-out basis. In other words, the withdrawal will not be taxable but it will reduce her basis.[4]

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Let's look at what would happen if Jane used withdrawals to pay off her loan, and then modified the *existing* contract to make it "reduced paid up" to avoid paying any more premiums, instead of doing a 1035 exchange to a *new* contract. The good news it that Jane still ends up with a policy with $160,000 of cash value and no taxable distribution to be reported. The bad news *might* be that the death benefit on the reduced paid up policy might be lower than it would have been if she did the exchange, and adding the LTC rider she wanted might not be an option.[5]

Paying Off Loan with Withdrawals to Basis	
Old policy cash value	$300,000
Old policy basis	$200,000
Policy value withdrawn to pay off loan	$140,000
New basis (old basis – withdrawal)	$60,000
Cash value of policy after withdrawal	$160,000

Could Jane use withdrawals to basis to pay off the loan, and then afterwards exchange the remaining cash surrender value for the new policy she wanted? *Maybe*. This is where the step transaction doctrine complicates matters. If Jane used withdrawals to pay off the loan and did a 1035 exchange within the same month, for instance, this would appear suspiciously like a two-step transaction with the same economic substance as *canceling* the loan at the time of exchange; therefore, the step transaction doctrine suggests they should be taxed the same. Spacing the transactions out by several months *may* help,[6] but the key question is whether the two transactions are part of a single plan.

The step transaction doctrine technically is a rule that the IRS might apply on audit. In practice, however, much depends on how carriers interpret it when they issue Form 1099-Rs. It is best to find out the carriers' policies for these types of transactions by contacting their advanced sales departments *before* beginning the 1035 exchange process!

Other Options for Handling Exchanges with Loans

When waiting to do a 1035 exchange is not a good option, Crump can help identify carriers that will "carryover" a loan in a 1035 exchange. Certain insurance companies will "mirror" the loan on the old policy immediately prior to the 1035 exchange, on the theory that if the loans on both sides of the transaction are equal, there is no "boot." The policy owner may be able to use policy values or other funds to pay down the loan in the future, or leave the loan in place if preferred. This is referred to as "loan rescue." Each carrier has different requirements for loan-to-cash value ratios and other particulars, if they allow loan carryover at all, so it is important to consult with a Crump teammate who is knowledgeable about these options. Moreover, the client should be aware that a Form 1099-R may still be generated by the old carrier, and it is the responsibility of the taxpayer to explain why the loan cancellation is *not* taxable.

Another option for some clients is to take out a short-term loan from some other source to pay off the loan on the original policy.[7] Then after making the 1035 exchange, they can borrow[8] from the new policy to pay off the short-term loan. Possible sources of short-term third party loans include lines of credit from a bank or brokerage firm, home equity loans, or even credit card advances if the terms are favorable enough. This allows more flexibility in choosing the new carrier and product to receive the 1035 exchange, but clients should always be sure to educate themselves on the fees, terms and conditions, and risks before entering into any financial transaction.

For more information on this topic, please contact your TIME regional specialist.

[1] Technically, insurance policies have "investment in the contract" under § 72 of the Tax Code, which operates much like "basis," but there are some crucial differences from the taxation of capital assets that have true basis. For instance, the investment in the contract does *not* get "stepped up basis" when a non-insured owner dies, and the surrender value of a contract in excess of the investment in the contract is taxed as ordinary income, not capital gains. Under Sec. 72, only non-MEC life insurance receives favorable "first-in, first-out" (FIFO) treatment for partial distributions from the contract, in which withdrawals are treated as a tax-free return of basis until there is no more basis left.
[2] Section 1035(d) directs that the rules for gain or loss recognition in Section 1031 apply to exchanges of insurance contracts that are not solely in kind. Section 1031 requires "last-in, first-out" (LIFO) recognition of gains first before return of basis.
[3] Even if there are no immediate tax savings, 1035 exchange treatment may be beneficial in this type of situation if trying to make sure that the new policy is not a modified endowment contract.
[4] Withdrawals to basis can potentially trigger "recapture" taxes in the first 15 years of the policy under certain circumstances, but that is not a concern in this scenario.
[5] To act in the best interest of the client, insurance professionals should explore options for modifying an existing contract before seeking replacement. If the desired features are available on the existing contract, with or without additional underwriting, this *may* be a less expensive means of achieving the client's goals than purchasing a new policy.
[6] Revenue Procedure 2011-38 provides a safe harbor for 1035 exchanges of *annuities*, so long as no distributions are taken from the annuity within 180 days *after* the exchange. This does not directly address the question of life insurance or distributions *before* a 1035 exchange, so the 180 day timeframe is suggestive rather than authoritative.
[7] Certain limitations may apply if the original or new policy is a variable policy and the policy will be used as collateral for the loan.
[8] Withdrawals instead of loans on a new policy risk running into problems with the step transaction doctrine and/or the recapture tax.