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A graduate of the University of Notre Dame with a BA in economics, Towers received his Juris Doctor from Suffolk University Law School. He has delivered advanced planning seminars to life insurance professionals and has lectured to Society of Financial Service Professionals chapters, estate planning councils, financial planning associations, and attorney and CPA professional groups across the United States.

Towers' area of expertise is estate, business and retirement planning for wealthy business owners, executives and professionals, and he provides customized case consultation for advanced legal, tax and insurance plan designs. He has written many articles for industry publications.

Towers received his CLU/ChFC designations from The American College and is a member of the National and Rhode Island Societies of Financial Service Professionals (SFSP) and has served as president of the Rhode Island chapter. A member of the Rhode Island Bar Association for more than 30 years, he is also a member of the prestigious Association for Advanced Life Underwriting (AALU), the National and Rhode Island Associations of Insurance and Financial Advisors (NAIFA), and the Rhode Island and Boston Estate Planning Councils. He is registered with FINRA as both a representative and a principal.

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Section 1035 Exchange Of Insurance Policies With Loans Requires Careful Attention

IRC Section 1035 allows tax-free exchanges of life insurance policies in a gain position (gross cash value greater than cost basis) so that these cash values can be easily transferred to more financially efficient policies. Sometimes significantly greater death benefit and/or significantly lower premium can result from the exchange in addition to desirable contract guarantees. However, some of these transactions involve existing contracts where policy loans (plus accrued interest) have previously been taken by the policyowner.

- ✔ What are the tax consequences of discharging (eliminating) a loan on an old policy during the process of an exchange to a new policy?
- ✔ What are the tax consequences of carrying over a loan to a new policy?
- ✔ Conversely, what are the tax consequences, if any, of paying off a loan on the old policy during the process of an exchange to a new policy?

Unsuspecting policyowners may inadvertently generate taxable income when executing an apparent tax-free exchange if care is not undertaken on exchanges of policies with loans.

Here are a few tips about doing Section 1035 exchanges on insurance policies with loans to avoid the unintended result of taxable income.

Basic Taxation of 1035 Exchanges for Policies with Loans

When no loans exist on a policy the exchange of an old policy in a gain position for a new policy is tax-free.

When existing loans are discharged (eliminated) during the exchange of an old policy in a gain position, the amount of the loan up to the extent of the gain in the policy is currently taxable as "boot" income. (Said another way, the lesser of the policy loan or the policy gain is taxable "boot" income, Treasury Regulation 1.1031(b)-1(c).) The new policy is issued without an outstanding loan, since the debt (loan) was discharged (eliminated) upon the exchange.

When loans exist on a policy and the loans are carried over from the old policy in a gain position to the new policy upon the exchange, the exchange is tax-free (PLR 8806058; PLR 8604033; PLR 8816015). The new policy is issued with an outstanding loan equal to the loan on the old policy. Verify that the new carrier will accept this carry-over loan on the new policy.

Loan Payoff Options

What are the loan payoff options for both pre-exchange and post-exchange? For purposes of the four loan payoff scenarios below, assume the following facts:

Policy Face Amount	$1,000,000
Cost Basis	200,000
Gross Cash Value	300,000
Policy Loan	50,000
Net Cash Value	$250,000
Tax-Deferred Built-In Gain	$100,000

Situation One. Pre-exchange payoff of a $50,000 loan on an old policy in gain position via $50,000 cash withdrawals from the old policy.

The IRS held in PLR 9141025 that a cash withdrawal from an existing policy to pay down a loan will be treated as taxable "boot" income if it occurs shortly before the exchange to a new policy. On the facts above, this would result in $50,000 of taxable "boot" income upon the exchange. This risk may be diminished somewhat if the loan payoff is completed long before the exchange.

The question revolves around what is a reasonable time interval between the payoff of the loan and the policy exchange. Some advisors feel that at least one year should lapse. Others are comfortable with a six-month interval, especially if the steps to the transaction occur in separate tax years. Clients are urged to consult their tax advisors on this fact pattern.

Situation Two. Pre-exchange payoff of a $50,000 loan on an old policy in gain position using $50,000 personal funds from outside the policy.

Use of personal cash funds to pay off the loan prior to exchange would not be "boot" income, since the policyowner is not receiving any cash from the policy.

Situation Three. Post-exchange payoff of a $50,000 carried-over loan to a new policy in a gain position via $50,000 cash withdrawals from the new policy.

In PLR 8816015, the IRS held that a post-exchange cash withdrawal from a new policy to pay down a Section 1035 carried-over loan *did not result* in "boot" income. The carry-over of the loan to the new policy was held to be a tax-free exchange, and the subsequent withdrawal from the new policy to pay off the loan was held to be a tax-free withdrawal of cost basis under Section 72(e)(5). Nevertheless, it may be prudent in light of PLR 9141025 (see pre-exchange, Situation One above) to let a reasonable time interval lapse between the carried-over loan and the loan payoff. Again, what is considered a reasonable interval has not specifically been addressed by the IRS.

In addition, beware of violating the definition of life insurance under the IRC Section 702(f)(7) rules when post-exchange withdrawals are made to pay down the carry-over loan.

Withdrawals that reduce the death benefit in the first five years after the exchange require a guideline single premium test under IRC Section 7702(c). Proceed with caution by working with a carrier's experts to validate that post-exchange withdrawals do not violate the definition of life insurance. A post-exchange violation of the guideline single premium test in the first five years will generate a Form 1099R taxable "force out" from the carrier for contracts in a gain position.

Situation Four. Post-exchange payoff of a $50,000 carried-over loan to a new policy in a gain position using $50,000 personal funds from outside the policy. Use of personal cash funds to pay off the carried-over loan after the exchange would not be "boot" income, since the policyowner is not receiving cash from the policy.

A Section 1035 exchange offers a policyowner the opportunity to substantially increase the death benefit and/or substantially decrease premium outlay. When a guaranteed death benefit universal life contract is involved, these "no-lapse" provisions offer strong financial guarantees which are generally not available with other types of permanent life insurance.

The details of Section 1035 transactions can be complex and require careful analysis. Section 1035 exchanges of policies with loans may apply to corporate, personal or trust-owned policies. Remember, the policyowner must be the same before and after the exchange. And multiple life insurance policies can be exchanged (two for one, three for one, etc.) as long as each existing policy has the same owner.