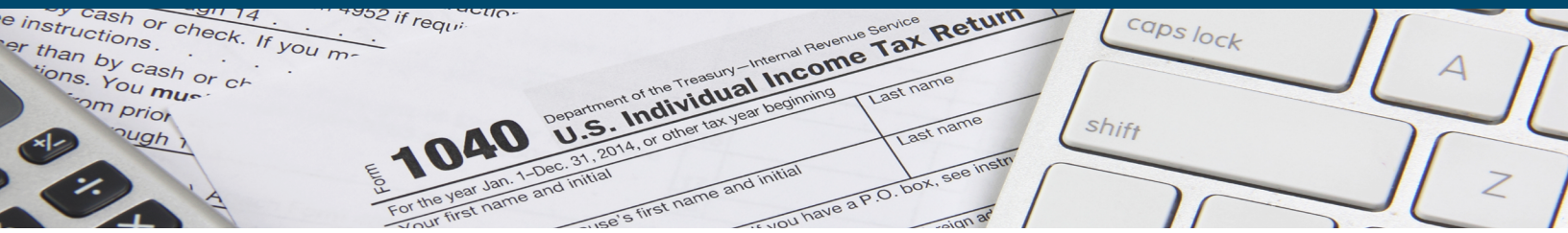

What are the Tax Implications of Code Section 1035 with a Policy Loan?

Situation: In the previous *Counselor's Corner* article, we discussed how Section 1035 permits tax-free exchanges of life insurance policies. That article provided a detailed discussion of how to structure a life insurance exchange to qualify for Section 1035 tax treatment. In a nut shell, to qualifying for tax-free exchange treatment under Section 1035 the transaction must be a "like-kind" exchange.

In contrast, if money or other non-like-kind property (referred to as "boot") is received in the exchange the transaction will not qualify for tax-free exchange treatment.[1] If boot is received as part of a life insurance exchange, gain will be recognized and taxed to the policy owner to the extent of the boot received.[2] A situation where unsuspecting policy owners may inadvertently generate taxable income involves exchanges of policies with preexisting loans. Depending on how the transaction is structured, the loan may fall into the trap of being recognized as boot, causing the exchange to be subject to taxation. This *Conselor's Corner* provides tips on doing Section 1035 exchanges on insurance policies with loans to avoid taxable income.

Solution: A couple of general points are worth noting before we get into a discussion of the various ways exchange transactions involving policies with existing loans have been structured in an attempt to avoid taxation. First, if the original policy with the loan is in a loss position (policy basis exceeds cash surrender values) there may be less of a concern about complying with Section 1035 requirements.[3] This can open more options to structuring the transaction. Second, where the transaction involves several policies, it's not possible to net one policy gain against another policy loss. The tax status of each policy must be considered. However, while gains and losses cannot be netted, it is possible to avoid tax on the surrender of a policy in a loss position and use the cash to pay off or down the loan on a policy in a gain position.

Clearly, a key aspect in deciding how to structure an exchange is knowing the tax status of the existing policy(s). This means that before executing an exchange you will want to get the tax basis, loan amount, and policy cash value from the original carrier(s) (ask for a taxable gain calculation). Unfortunately, despite its critical importance many skip this step. Now let's consider some of the ways exchange transactions involving polices with existing loans have been structured. Assume all the following situations involve policies in a gain postion (cash surrender value exceeds policy basis).

Policy Loan Extinguished in Exchange. If there is a loan against the original policy in an exchange, but no loan (or a lower loan) against the policy received in the exchange, the difference is treated as cash received. Specifically, Treasury Regulation under IRC §1031 provide that the assumption of a liability or a transfer subject to liability is to be treated as "other property or money." Thus, if a policy with a loan is exchanged for a new policy without a loan or lower loan, the loan amount extinguished will be considered boot.

For example, an owner has a life policy with $100,000 cash surrender value and a $60,000 basis subject to a $20,000 policy loan. The owner exchanges it in a Section 1035 transaction for a new policy with $80,000 cash surrender value and no loan. Because the loan was not carried over to the new policy, it will be treated as boot. As a result, the owner will recognize $20,000 gain (gain up to the value of the boot) as part of the transaction.

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[1]*Technically, an exchange of life insurance involving boot does not fall under IRC §1035, but under IRC §1031, which provides for partial nonrecognition.*

[2]*Treas. Reg. § 1.1035-1(c); IRC 1031(b) and (c). Where a life insurance exchange qualifies as a like-kind exchange under Section 1035 the basis of the new contract is equal to the basis of the original contract. In contrast, where boot is received in an insurance exchange transaction the basis of the new contract after the exchange is equal to the basis of the original contract, less the cash received, plus the amount of any gain recognized.*

[3]***Loss in Original Contract:** Where the original contract is in a loss position, neither gain nor loss may be recognized. For example, an owner exchanges a contract with a $20,000 cash surrender value and a $50,000 basis for a policy with a $15,000 cash surrender value and $5,000 cash. The basis in the new contract is $45,000 ($50,000 -$5,000 cash + 0 gain).*

Policy Values Used to Extinguish Loan Immediately Before Exchange. Generally, §72 allows an owner of a life insurance contract to withdraw policy cash values up to the basis in the contract without recognizing gain. This allows the policy owner to recover her basis in the life insurance contract while leaving the gain inside the policy. Following this logic, a policy owner may be tempted to extinguish the loan by executing a partial surrender of the policy before effecting an exchange of the now unencumbered policy. However, in PLR 8905004, the IRS held that the withdrawal rules of §72 cannot be used to circumvent the boot recognition rules of §1031.

In fact, in PLRs 8905004 and 9141025 the IRS viewed the use of policy values to pay down a loan followed by an exchange as a step transaction. Thus, the partial surrender and exchange was treated as an exchange with boot in an amount equal to the debt extinguished. As a result, the policy owner was immediately taxed on the partial surrender to pay off the loan. The risk of taxation may be diminished if sufficient time gap occurs between the partial surrender of policy values and the exchange. What constitutes a reasonable time has not been addressed by the IRS. Some advisors feel that a year should pass, while others are comfortable with six months, especially if the two transations occur in different tax years. Taxpayers are urged to consult their own tax advisors.

Policy Loan Carried Over to New Policy. If all of the cash value in an existing policy and the entire loan is carried over from the old policy to the new policy, then there is no receipt of other property or money and no gain is recognized.[4] A key point to consider with this form of transaction is that the acquiring carrier must be willing to carryover the entire loan and the old carrier must be willing to transfer over the loan. Not all carriers are willing to carry loans and those that are willing to mirror the loan there often are loan to cash value ratio limitations.

For example, owner executes an exchange of a policy with $100,000 cash surrender value and a $60,000 basis subject to a $20,000 policy loan for a new life policy with a $100,000 cash surrender value and a $20,000 policy loan. Because the entire policy values and loan amount was carried over to the new policy no gain is recognized.

Policy Values Used to Extinguish Loan Immediately After Exchange. Where a policy and loan is carried over to a new policy, a policy owner may seek to extinguish the loan by using the values of the new policy. In PLR 8816015 the IRS held that a partial surrender of policy values to pay down a loan after a Section 1035 exchange did not result in boot income. However, in light of PLR 9141025 (noted above) it would be prudent to allow a sufficient time gap between the exchange and the loan pay off using policy values. In addition, it should also be noted that a loan pay off through values within the first fifteen policy years may result in tax under §7702.

Using Outside (Non-Policy) Funds to Eliminate Loan Before of After the Exchange. Where a carrier is not willing to carry a loan a policy owner may use funds not associated with the life insurance policy to pay off the loan before the exchange. You may also use outside funds to pay to eliminate a loan after the exchange, although this technique in not used as often. This will not trigger taxation under boot because using outside funds is not considered the recipt of "other property or money" in conjunction with a Section 1035 exchange. In addition, the repayment of the loan by the policy owner is not considered a relinquishment of a liability as part of a Section 1035 exchange.

Where boot is received in an insurance exchange the basis of the new contract after the exchange is equal to the basis of the original contract, less the cash received, plus the amount of any gain recognized as follows:

- **Gain Greater than Boot:** Where gain in the original contract exceeds boot, the entire boot represents gain. For example, an owner exchanges a policy with $30,000 cash surrender value and a $10,000 basis for a new policy with $20,000 cash surrender value and $10,000 cash. The transaction is taxable to the extent of $10,000 cash received. The basis in the new contract is $10,000 ($10,000 basis- $10,000 cash received + $10,000 gain recognized).

- **Boot Greater than Gain:** Where the gain in the original contract is less than boot, the boot represents a distribution of both gain and a return of basis. For example, an owner exchanges a policy with $45,000 cash surrender value and a $40,000 basis for a new policy with $35,000 cash surrender value and $10,000 cash. The transaction is taxable to the extent of $5,000 gain and the other $5,000 is not taxed but is considered a return of basis. The basis in the new contract is $35,000 ($40,000 basis- $10,000 cash received + $5,000 gain recognized).

Summary. If the original insurance policy to be exchanged has an outstanding loan and there is gain in the contract, the most common way to avoid taxable gain is to arrange for the new carrier to assume the existing loan, but other alternatives are available.

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[4]PLRs 8604033, 8806058 and 9044022.

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