Tax-Free 1035 Exchanges Quick Reference Guide

Genworth Financial

Under Internal Revenue Code Section 1035

In general, IRC Section 1035 allows the investment and gain in a non-qualified life insurance policy, endowment policy or annuity contract to be transferred to another policy or contract without having to pay tax on the gain at the time of the exchange. Instead, the gain carries over to the new policy or contract. A section 1035 exchange lets your customer move to a new policy or contract as circumstances or needs change. It is an opportunity that is suitable in some situations, but not in others.

Not all policy or contract exchanges are tax-free. For example, an annuity contract cannot be 1035 exchanged for a life insurance policy. Additionally, there are rules pertaining to the ownership, insured and/or annuitants before and after the exchange. The following table summarizes those exchanges that are generally permitted, but should not be considered an exhaustive list. *Unless otherwise indicated, "annuity" means either a deferred or immediate annuity contract.*

Tax-Free 1035 Exchange From	To a New Policy or Contract
Life Insurance Policy[1]	• Life insurance policy with the same owner(s) and insured(s)[2] • Annuity contract with the same owner(s)[3] • Multiple life insurance policies and/or annuity contracts each having the same owner(s). Exchanges to life insurance policies must also have the same insured(s) • Life insurance policy with a long term care insurance (LTCI) rider with the same owner(s) and insured(s) • Tax-qualified[4] long term care insurance policy[5] with the same owner(s) and insured(s)[6] • Annuity contract with a LTCI rider with the same owner(s) and insured(s)
Two Life Insurance Policies With the Same Owner(s) and Insured(s)	• One life insurance policy with the same owner(s) and insured(s) • One annuity contract with the same owner(s)
Second-to-Die Life Insurance Policy	• Second-to-die life insurance policy with the same owner(s) and insureds
Second-to-Die Life Insurance Policy (after the death of one of the insureds)	• Life insurance policy with the same owner and sole survivor as insured
Part[7] **of the Cash Value In a Life Insurance Policy**	• Tax-qualified LTCI policy with the same owner(s) and insured(s)
Deferred Annuity Contract	• Annuity contract with a LTCI rider with the same owner(s)[8] • Annuity contract with the same owner(s)[9] • Multiple annuity contracts with the same owner(s) • Tax-qualified LTCI[10] policy with the same owner(s)
Two Deferred Annuity Contracts With the Same Owner(s)	• One annuity contract with the same owner(s)
Part of the Funds In a Deferred Annuity Contract	• Deferred annuity contract with the same owner(s)[11] • Tax-qualified LTCI policy with the same owner(s)
Immediate Annuity[12]	• Tax-qualified LTCI policy with the same owner(s) and with annuitants the same as the insured(s)
Tax-Qualified LTCI Policy	• Tax-qualified LTCI policy with the same owner(s) and the same insureds[13]

Exchange of Life Insurance Policy With Outstanding Loan Balance

When a life insurance policy with an outstanding policy loan is exchanged for another life insurance policy, the loan will be considered "boot" and subject to income taxation to the extent of any gain in the original policy, unless the loan is carried over to the new policy. If the loan is paid off before the exchange using cash values from the original life insurance policy, the IRS may regard the payment of the loan and the 1035 exchange as one integrated transaction, and treat the loan as "boot". The safer approach may be to pay the loan using funds from sources other than the life insurance policy that is being exchanged.

Loans against annuity contract values are income taxable to the contract owner to the extent of gain in the contract. Therefore, an attempt to exchange a life insurance policy with an outstanding loan for an annuity contract will result in the loan being treated as "boot" and taxable to the owner to the extent of gain in the original policy.[14]

Important Information

The tax information in this material was written to support the promotion and marketing of the contract. The Genworth Financial companies and their representatives and distributors do not provide tax or legal advice. We did not write this material for use by any taxpayer to avoid any Internal Revenue Service penalty. Your client should ask their independent tax and legal advisers for advice based on their particular situation.

[1] Note: A life insurance policy with a long term care insurance rider (also known as a linked benefit or hybrid life insurance policy) is treated as a life insurance policy, not a long term care insurance policy for section 1035 exchange purposes.

[2] Although section 1035 does not require that the owners stay the same when exchanging life insurance policies, a change of ownership may have income, gift or estate tax consequences. Please Note: The Genworth Financial companies will not process a section 1035 exchange between life insurance policies without ownership being the same.

[3] Section 1035 is silent as to the requirements for exchanges between life insurance policies and annuities. We know that for exchanges between life insurance policies, the insured(s) must be the same, and for exchanges between annuities, the "obligee(s)" – owner(s) – must be the same. An annuitant and an insured, though, are not the same and in most cases the Genworth Financial companies do not require they match when exchanging a life insurance policy for an annuity contract. It is the transferring insurance company, though, who is responsible for tax reporting 1035 exchanges. Some companies may require that insureds and annuitants match in order to exchange a life policy for an annuity, so you must check with the transferring carrier as to their 1035 exchange requirements. Make sure that your customer has independent tax and legal advice on this and all other section 1035 exchange issues.

[4] Tax-qualified long term care insurance is provided by a policy that meets the requirements of IRC Sec.7702B(b). It must provide only for the payment of qualified long term care services, may not reimburse for expenses ordinarily reimbursable by Medicare or Medicaid, must be guaranteed renewable, cannot have any loan or surrender value, require premium refunds or dividends to reduce future premiums or increase benefits, and must meet certain disclosure and non-forfeiture requirements.

[5] "LTCI" is used herein to mean a traditional long term care insurance policy. A 1035 exchange from a life insurance policy to either a life insurance policy or annuity contract with a linked benefit long term care insurance rider is also permitted.

[6] Section 1035(a) as amended by the Pension Protection Act of 2006 provides that, beginning in 2010, no gain or loss shall be recognized on the exchange of a life insurance policy for a qualified long term care insurance policy, or on the exchange of an annuity for a qualified long term care insurance policy.

[7] Since most LTCI policies are paid on an annual premium basis, annual partial 1035 exchanges may be the most practical funding approach.

[8] Note: An annuity contract with a long term care insurance rider (also known as a linked benefit or hybrid life insurance policy) is treated as an annuity contract, not a long term care insurance policy for section 1035 exchange purposes.

[9] An exchange of a deferred annuity for an immediate annuity usually does not qualify for the immediate annuity exception to the 10% penalty tax (even though it is a valid 1035 exchange). The IRS has ruled that if a deferred annuity is exchanged for an immediate annuity, the original purchase date of the deferred annuity is also the purchase date of the new annuity. Because an immediate annuity is one in which annuity payments begin within one year of purchase, the actual annuity purchase date is critical for purposes of this exception.

[10] "LTCI" is used herein to mean a traditional long term care insurance policy. A 1035 exchange from a deferred annuity to an annuity contract with a linked benefit long term care insurance rider is also permitted. An annuity cannot be exchanged for a life insurance policy of any kind, even if the life policy has a long term care insurance rider.

[11] According to Revenue Procedure 2008-24, withdrawals from either the original or new annuity contract within the first 12 months after the exchange may cause the 1035 exchange to fail and the abortive exchange amount treated as a distribution, unless the withdrawal is related to a "life event" such as a divorce or loss of employment, or if it meets one of the other exceptions identified in the Revenue Procedure.

[12] A 1035 exchange from an immediate annuity would be an assignment of rights in the contract equal to the LTCI premium payments.

[13] IRC Sec.1035(a)(4) provides that no gain or loss shall be recognized on the exchange of a qualified long term care insurance policy for another qualified long term care insurance policy.

[14] PLR 9141025