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Updating Your Life Insurance Portfolio Under IRC Section 1035

Why?

How?

Tax Impact?

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Guarantees are rare in today's financial environment. One guarantee that has been consistent is that things change over time – financial products evolve, our clients' financial situation changes, children age, etc. Nobody can predict with certainty what the future will hold and it is our responsibility as financial advisors to provide our clients with flexibility and expert advice to adjust to changes as they arise.

Life insurance products are based on a set of assumptions about interest rates, mortality and persistency. There have been changes in recent years that improve product pricing and may provide opportunities for clients to update their life insurance portfolios with a lower expense structure:

- People live longer – advances in technology and medical procedures have extended life expectancies resulting in lower mortality expenses
- New Mortality Tables – in 2010, state insurance regulators required all insurance companies to extend their mortality tables to age 120; the result is a longer period of time to spread mortality risk which may translate to lower expenses

Why Update a Policy?

As a result of these changes, as well as changes in a client's personal situation, there are many reasons to update a life insurance portfolio:

- Lower expenses may allow for a reduction in premiums and/or higher death benefits
- The existing policy may not perform as expected due to a reduction in interest rates or changes in the premium funding
- Policies based on current pricing may extend coverage that is illustrated to lapse
- Transition to a carrier with better ratings and financial stability
- Change the investment risk profile of the underlying cash values – new products may provide more investment alternatives with different risk characteristics
- Combine the life insurance with other benefits such as Long Term Care

What Products are Available for Exchange?

One of the key advantages of life insurance is tax deferred growth of the underlying cash value. In most cases, it is important to ensure any gains in the policy cash values retain their tax-deferred nature.

Tax Advantages of Life Insurance

- **Tax-Deferred Cash Value Accumulation**
- **Income Tax-Free Death Benefits**
- **Ability to Own the Insurance Outside of the Estate**

If it is determined that it is in the client's best interest to update the coverage, the IRS provides some advantageous tax treatment if certain criteria are met. Internal Revenue Code (IRC) Section 1035 allows a life insurance policy to be exchanged to certain products with no recognized gain. Section 1035 specifically allows a tax-free exchange from a life insurance product to any of the following products:

- Another life insurance policy
- An endowment
- An annuity
- A qualified long-term care policy

What are the Requirements?

To qualify for the tax-free status under Section 1035, certain requirements must be met.

The insured(s) in the new policy must be same as the insured(s) in the policy replaced. Because the insureds must be the same, a Section 1035 exchange from a single-life policy to a joint-life policy is not allowed.

The owner of the policy must remain the same both before and after the exchange. The owner cannot be changed (such as from an individual to a Trust) as part of the Section 1035 exchange.

If these requirements are not met, any exchange or replacement of a life insurance policy may have adverse tax consequences.

Other Considerations

In most cases, a Section 1035 exchange is a straight-forward process. However, there are situations that warrant special attention:

Boot Transactions A boot transaction occurs when the policyowner receives additional payment of cash or other property as a result of the exchange. In this case, the boot will be considered recognized gain.

Policy Loans The most common example of a boot transaction is the termination of a policy loan as part of the exchange. If there is a policy loan, the policyowner should either use funds outside of the policy to repay the loan or carry the loan over to the new policy.

Contestability	The new policy will have a new contestability and suicide periods.
Acquisition Costs	There are acquisition costs to exchange existing coverage for new coverage. As part of the due care process, the advantages of the new policy must outweigh these costs.
Underwriting	The insureds must complete medical underwriting to qualify for the new coverage.

Summary

There are many reasons it may make sense to update a life insurance portfolio. Section 1035 may provide an opportunity to exchange life insurance policies to better meet a client's needs without any adverse tax consequences. Before committing to a change, it is important that the client consider multiple alternatives and it is the advisors' responsibility to ensure the change is in the client's best interests.

Life insurance exchanges under Section 1035 may involve a number of factors and clients should work with experienced life insurance professionals to ensure the change is consistent with the client's objectives and to avoid any adverse tax consequences.