



IRC § 1035 Exchanges and Policy Loans

Question: Can gain recognition and taxation be avoided in an IRC § 1035 exchange if the life insurance policy is subject to an outstanding loan?

Answer: Yes, if care is taken to structure the transaction properly, any gain in the policy can be deferred under IRC § 1035, even when a policy has an outstanding loan.

IRC § 1035(a) provides that no gain or loss is recognized on the exchange of a life insurance contract for another life insurance contract.¹ The new contract is treated as a continuation of the original contract and the cost basis of the new policy generally will be the same as the cost basis of the old policy (carryover basis treatment) plus any additional premiums paid less any excludable dividends received after the exchange.

However, the regulations governing IRC § 1035 exchanges provide that if money or other non like-kind property (referred to as “boot”) is received in a tax-free exchange, gain will be

recognized and taxed to the extent of the cash or other property received.²

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. The smaller of this amount or any gain in the original policy is taxable income. There is a gain if total cash values, including loans, are greater than total premiums paid less dividends (if any). If there is no gain, then there is no tax and the amount of loan reduction simply reduces basis in the policy.

Obviously, any loan reduction that is part of an IRC § 1035 exchange has the potential to cause problems.

Suppose a policy owner wants to exchange a life insurance policy with a large outstanding loan and he wants to pay off the loan by withdrawing from the policy and then exchanging the balance of the policy for a new policy with another carrier? Will the withdrawal be considered a tax-free return of basis under IRC § 72(e) and will the exchange qualify for tax-free treatment under IRC § 1035? Not according to private letter ruling 9141025.

¹ *Treas. Reg. § 1.1035-1(c) provides that non-recognition treatment is limited to cases where the contracts relate to the same insured.*

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² *Treas. Reg. § 1.1035-1(c); IRC 1031(b) and (c).*

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Here, the IRS viewed the withdrawal and exchange as a “step-transaction.” Under the step transaction doctrine, all steps taken to achieve an intended result are viewed as a single transaction rather than analyzed as separate taxable events. As a result, the IRS treated the policy owner’s withdrawal and exchange as one IRC § 1035 exchange with boot in an amount equal to the debt extinguished. As a result, the policy owner was immediately taxed on the withdrawal used to pay off the policy loan.

Although the IRS has applied the step-transaction doctrine where withdrawals were used to purchase another contract or to pay off a policy loan, they have not pursued bare withdrawals. It is interesting to note that the IRS seems particularly interested in distributions made prior to an IRC § 1035 exchange, but has not overtly attacked distributions from the new policy – even those made shortly after the exchange.³

Additionally, the IRS has indicated that a policy loan can avoid being treated as boot in a IRC §1035 exchange if the carrier that issues the new policy is willing to carry the loan over to the new policy.⁴

In Summary: If the insurance policy to be exchanged has an outstanding loan and there is gain in the contract, the most common way to avoid having to recognize taxable gain is to arrange for the new carrier to assume the existing loan. (Prudential will carry over policy loans on an exchange in situations where there is substantial cash value remaining in the policy.) If an insurance company will not allow a loan carryover, the policy owner should pay off the loan on the old contract before making the IRC § 1035 exchange using money from an independent source. If there is gain in the

policy, using withdrawals from the old contract to pay off the loan and then exchanging the same policy for a new policy should not be done since this could be treated as a step-transaction resulting in taxable boot.

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³PLR 8816015.

⁴ PLRs 8604033 and 9044022.