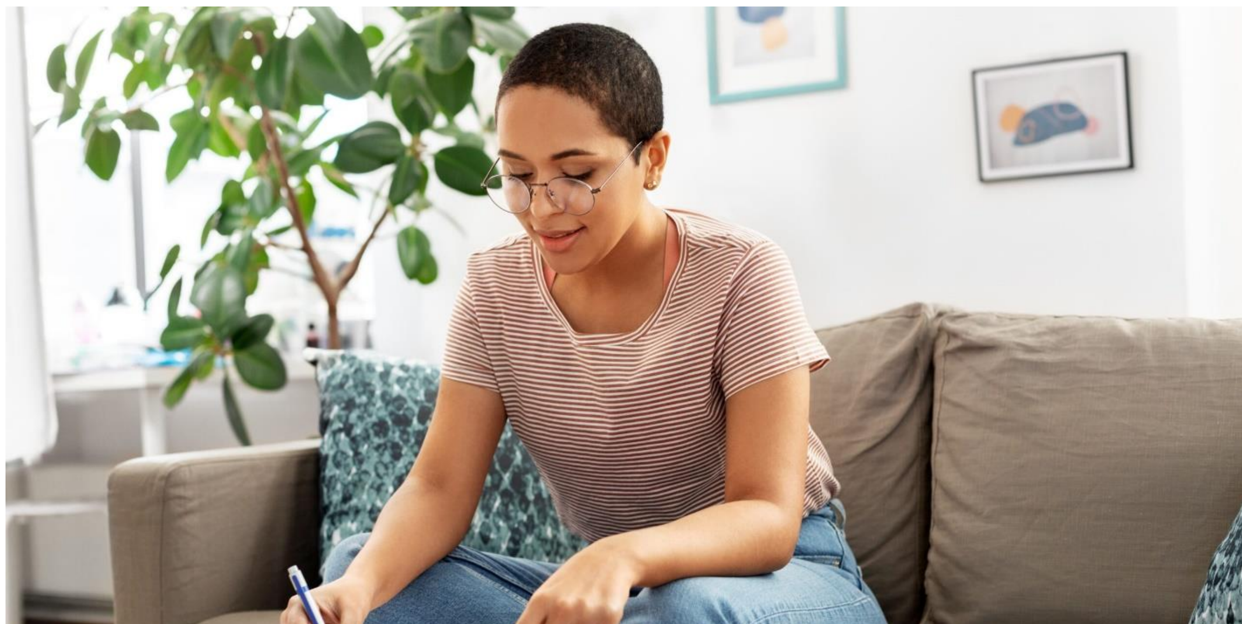
Navy Mutual

Tax Implications of 1035 Exchanges



Typically, when a policy owner withdraws money from or surrenders (cancels) a permanent life insurance policy or an annuity, the IRS requires them to pay ordinary income taxes on any amount of money that was earned on premium deposits (normally through accrued interest). Until a withdrawal or surrender is made, the cash value of these products grows tax deferred. Taxes are not assessed until money is distributed from the policy.

- For an in-force life insurance policy, taxes are usually owed when the proceeds received by the policy owner through a withdrawal or the surrender of the policy exceed the premiums that were paid into the policy. Taxes are levied on the difference between the portion of the payment that equals the premiums paid into the policy and the total payment received. In other words, only the portion of the payment to the policy owner that comes from income earned by the policy is taxed.
    - The death benefit of a life insurance policy is typically paid out tax-free, but any interest earned on the death benefit settlement is usually taxable.
- Similarly, a non-qualified annuity owner pays taxes on the amount of interest earned on annuity premium contributions when making a withdrawal from or surrendering the annuity. Further, an annuity owner normally would also owe taxes on accrued interest after annuitizing the accumulated value into income payments.
    - The owner of an annuity is taxed on any interest distributions that the annuitant (the person who receives payments from an annuity) receives. Annuity beneficiaries are taxed on their share of accumulated interest contained in settlement proceeds. Ordinarily, only the interest accrued on a non-qualified annuity is taxed.

Taxes on the earned income (i.e., accrued interest) portion of annuity installment payments made to an annuitant or the benefit payout life insurance beneficiary are due for the year

during which the funds are received. The company distributing income payments will supply the policy owner with a 1099 for tax reporting purposes.

Sometimes, though, an individual may want to use money that is contained within a life insurance policy or an annuity to purchase *a different* life insurance policy or annuity because their needs have changed over time. In those situations, the IRS allows for a tax-exempt transaction called a 1035 exchange.

What is a 1035 exchange?

A 1035 exchange is a transfer of funds from a current permanent life insurance policy, long-term care contract, or annuity to a new policy, contract, or annuity that does not create a tax liability.

- Funds from a life insurance policy can be rolled into a new life insurance policy, a long-term care contract, *or* an annuity.
- Funds from an annuity can be rolled into a new annuity *or* long-term care contract.
- Funds from a long-term care contract can *only* be rolled into a new long-term care contract.

When executing a 1035 exchange, the policy owner and the insured or annuitant must be the same between the old and new policies or contracts. Multiple life insurance policies can be rolled over into one, *so long as the policy owner and insured are the same between all contracts*.

> **Note:** If multiple life insurance policies are rolled into one, and at least one of the policies to be replaced is a Modified Endowment Contract, the new policy is also considered a Modified Endowment Contract.

What is a Modified Endowment Contract?

A Modified Endowment Contract (MEC) is a life insurance policy that was funded with more premium contributions than would otherwise be necessary to fully fund the same policy's death benefit over seven years – known as the Seven-Pay Test. MECs were first issued on or after June 20, 1988.

Insurance policies that are classified as MECs are taxed under a "last-in-first-out" presumption. In other words, the IRS presumes that *any interest contained in cash value was distributed first*, regardless of the owner's chosen method of receipt (e.g., policy loan offset, dividend as cash, partial or complete surrender of the policy). In addition, an assignment or change of ownership of a MEC to a non-spouse may result in an ordinary income taxable event to the grantor in the year of the distribution if the total value of the policy has increased, through accrued interest, beyond the value of premium payments made.

A multi-contract tax aggregation rule also applies to all MECs issued to the same owner in the same tax year. Consequently, any interest earnings on those contracts are presumed to have been dispersed first if a withdrawal, loan, or dividend distribution of cash value occurs during the lifetime of the insured.

In addition to last-in-first-out tax treatment, the IRS imposes a 10% penalty on any taxable gain distributed from the cash value of a MEC if the distribution occurs before the owner reaches

age 59 ½. However, any premium contribution returned to the owner in the form of a MEC cash value distribution is free of this 10% early distribution penalty. In addition, the distribution of cash value in an income stream over the life expectancy of the insured avoids the 10% excise tax under 72(t).

> Note: MEC tax treatment does not alter tax-deferred cash value accumulation within the contract or the tax-free nature of a death benefit settlement.

Why might someone execute a 1035 exchange?

There are any number of reasons why an individual may choose to partially or fully surrender a life insurance policy or annuity and move the funds to a new one. For instance, a person may want to transfer the funds in a life insurance policy to an annuity to eliminate charges that support the death benefit or to initiate income payments. Alternatively, they may decide that a new product has more attractive features than an existing policy or annuity.

A 1035 exchange preserves the policy's original cost basis even if there were losses due to poor investment market performance, cost of insurance charges, or surrender fees. For example, a variable life insurance policy purchased for $80,000 may only be worth $70,000 after a downturn in the market. If the policy owner chose to purchase a new policy through a 1035 exchange, the new policy could be purchased with the original cost basis of $80,000, thereby reducing the amount of taxable gains when payments are eventually made to the owner.

Note that the owner may still have to pay a surrender fee on the policy or contract that is being exchanged. Furthermore, clauses that may have expired on an older policy (incontestability or suicide clauses, for example) will be reinstated on the new policy until the expiration time has lapsed again.

How does a 1035 exchange work?

A 1035 exchange is relatively straightforward. If an individual has decided to take money out of an existing life insurance policy, long-term care contract, or annuity and transfer it into a new policy or contract, they will need to work with the insurer supplying the new policy or contract to initiate the transfer of funds. Typically, a policy owner will sign over ownership to the insurer, who then executes the 1035 exchange.

It is exceptionally important that, when executing a 1035 exchange, the policy owner does not touch the funds from the original policy or contract that are used to purchase the new product. To avoid a taxable event, the funds must be transferred directly from one insurer to another or within the insurer's company without the owner's "constructive receipt" of the proceeds.

> Initiating a 1035 exchange isn't a decision to make lightly. Consider your options and talk to a knowledgeable representative to ensure you fully understand the details and any possible tax implications or penalties associated with a policy's or contract's surrender. For help with a 1035 exchange, you can reach a Navy Mutual representative at 888-300-9331.