

TAX ASPECTS OF A PARTIAL SURRENDER ON A SECTION 1035 EXCHANGE WITH A BUILT-IN GAIN TO EXTINGUISH A POLICY LOAN

PERTINENT INFORMATION

- ❑ Mrs. Kugler has an ordinary whole life policy with a cash value of \$150,000. There is an existing loan of \$100,000. Mrs. Kugler's cost basis is \$100,000.
- ❑ She is considering an IRC Section 1035 policy exchange.
- ❑ Mrs. Kugler is aware that if the policyowner receives a current economic benefit from the policy exchange, the value of the benefit will be considered "boot" (deemed distribution) and treated as income.
- ❑ Note: An economic benefit may be attributed to the policyowner even though the net cash accumulation in the policy is not currently enhanced and there is no cash distribution to the policyowner.

GOALS AND OBJECTIVES

- ❑ Mrs. Kugler must give special attention to a 1035 exchange when the policy has an outstanding loan. If the entire loan is carried over to the new policy there should be no deemed distributions (boot) to the policyowner. However, if all or a portion of the loan is extinguished shortly before or after the 1035 exchange, a deemed distribution may occur.
- ❑ Note: It is common in a 1035 exchange for the policyowner to terminate the loan prior to the exchange. Typically, the policyowner will surrender a portion of the cash value and simply direct the insurance company to extinguish the policy loan to satisfy the partial surrender.
- ❑ Note: A partial surrender to extinguish a policy loan results in a reduction of the face amount and gross cash value of the ordinary policy. The net cash value (after loan amount) is not affected.
- ❑ A partial surrender to extinguish the loan will be considered a deemed distribution because the policyowner is considered to receive a distribution equal to the extinguished loan.
- ❑ Note: If the policyowner uses personal funds (including dividends from the existing policy) to pay off the loan, there would be no deemed distribution because the policyowner would simply be returning the cash previously borrowed from the policy. Personal funds could be obtained via a partial surrender or loan on a different policy to pay off the loan.
- ❑ Mrs. Kugler would like to review the tax aspects of the 1035 exchange if she does a partial surrender to extinguish the existing loan.

PROPOSED ARRANGEMENT

- ❑ The tax aspects will depend upon which section of the Internal Revenue Code covers the 1035 exchange.
- ❑ The key to receiving favorable income tax treatment is to have the partial surrender to extinguish the loan treated as one transaction and the 1035 exchange treated as a separate transaction.
- ❑ If the partial surrender is a separate transaction it will be covered under IRC Section 72(e), which governs the taxation of life insurance and allows the policyowner to recover cost basis before being taxed on any gain.
- ❑ The tax results would be the same as if the partial surrender to extinguish the loan were implemented in a separate transaction and not related to the 1035 exchange.

- ❑ Under IRC Section 72(e), the measure of the deemed distribution is limited to the amount by which the partial surrender to extinguish the loan exceeds the cost basis.
- ❑ If the partial surrender occurs “shortly before or shortly after” the 1035 exchange it will be treated as one transaction. It would then be taxed under IRC Section 1031, which essentially correlates to a “like-kind exchange” in a real estate transaction.
- ❑ Under IRC Section 1031, the policyowner does not have the benefit of recovering cost basis first. The deemed distribution (boot) is the lesser of the partial surrender to extinguish the loan or the built-in gain in the policy.

COMPUTING TAXABLE GAIN UNDER IRC SECTION 1035 EXCHANGE WHEN THERE IS A PARTIAL SURRENDER TO EXTINGUISH A LOAN ON A POLICY WITH A BUILT IN GAIN

If Section 1035 Exchange is considered

A Separate Transaction A Composite Transaction

	IRC SECTION 72 (e) APPLIES	IRC SECTION 1031 APPLIES
Cash Value Before Loan	\$150,000	\$150,000
Loan Amount	<u>100,000</u>	<u>100,000</u>
Remaining Cash Value	\$50,000	\$50,000
Partial Surrender*	\$100,000	<i>Lesser of:</i> { \$100,000 50,000
Cost Basis	<u>(100,000)</u>	
Built-In Gain		
Taxable Gain (Boot)	\$0	\$50,000**

* Most life insurance companies will allow the partial surrender via simply extinguishing \$100,000 of the outstanding loan. The result is the same as if the policyowner paid off \$100,000 of loan and then implemented a partial surrender for \$100,000 of cash value.

** The \$50,000 built-in gain (\$150,000 cash value less \$100,000 cost basis) is less than \$100,000 partial surrender.

- ❑ **Under IRC Section 72(e)** there is no taxable gain (\$100,000 partial surrender minus \$100,000 cost basis).
- ❑ Note: IRC Section 72(e) will produce a deemed taxable distribution in any situation where the partial surrender to extinguish the loan exceeds the cost basis.

- ❑ **Under IRC Section 1031** the policyowner does not have the benefit of recovering cost basis first. The entire \$100,000 partial surrender to extinguish the loan would be considered a deemed distribution. However, the taxable distribution cannot exceed the \$50,000 built-in gain (\$150,000 cash value minus \$100,000 cost basis). Mrs. Kugler would be taxed on the \$50,000 gain.
- ❑ IRC Section 1031 will produce a taxable distribution (boot) in any composite transaction 1035 exchange where the policy has a built-in gain and there is a partial surrender shortly before or shortly after the 1035 exchange.
- ❑ When the partial surrender is made just before or just after the 1035 exchange it is considered to be part of the 1035 transaction, which causes concern because IRC Section 1031 does not allow cost basis to be recovered first.
- ❑ Mrs. Kugler may want to consider the following options to help structure the transaction as two separate transactions: 1) personal funds to pay off the loan and not implementing the partial surrender, 2) implementing the partial surrender and postponing the 1035 exchange for several months, or 3) implementing the 1035 exchange and postponing the partial surrender for several months.

RESULTS AND BENEFITS

- ❑ A partial surrender to extinguish the loan is especially attractive in situations where the existing policy does not have a built-in gain. The policy must have a gain in order to generate a taxable event under either Section 72(e) or Section 1031. If there is no existing gain there should be no taxable distribution.
- ❑ Once the policy has a built-in gain, a partial surrender to extinguish the loan may cause a taxable event.
- ❑ IRC Section 1031 applies if there is a composite transaction. The elimination of the loan via a partial surrender will result in a deemed distribution taxable (boot) for the entire amount of the \$50,000 built-in gain. However, if Mrs. Kugler has sufficient personal funds (including dividends from the existing policy), she could pay off the loan herself. If personal funds are used there would be no need for the partial surrender and thus no deemed distribution (boot).
- ❑ If the partial surrender to extinguish the loan is made several months before or several months after the 1035 exchange, it should not be considered part of the 1035 transaction. In that situation, the partial surrender should be a separate transaction and taxed under IRC Section 72(e) which would allow recovery of basis before gain. Mrs. Kugler could then either pay off the remaining loan with personal funds or carry over the remaining loan to the new policy.
 - ❑ To qualify as a separate transaction (exchange and surrender) there should be a reasonable time period between each transaction. They should not occur shortly before or shortly after each other.
 - ❑ The IRS does not provide a specific time period to define "shortly before or shortly after."
- ❑ Note: If IRC Section 1031 is applicable and the 1035 exchange results in a decrease in the gross cash value, there may be an advantage to implementing the 1035 exchange after the partial surrender. The decrease in the cash value will reduce the built-in gain which may reduce the deemed distribution (boot). However, since a new policy is issued in the 1035 exchange, implementing the partial surrender after the 1035 exchange may cause a higher surrender charge applicable to the surrender to extinguish the policy loan.