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Pension Protection Act Opens New Opportunities in 1035 Exchanges. And Some Dangers.

The Pension Protection Act passed by Congress at the end of July and signed by the President on August 17, 2006, includes changes that affect exchanges of insurance products under §1035 of the Internal Revenue Code (IRC). This bulletin gives you a summary of the most significant changes, and outlines areas that require caution.

Scattered here and there among the almost 400 pages of the Pension Protection Act of 2006 (PPA), you'll find several changes affecting §1035 exchanges. Some are obvious. Some are not so obvious.

LONG TERM CARE INSURANCE POLICIES

Section 884 of the PPA adds long term care insurance policies to the list of insurance products that may be exchanged free of federal income tax.

In general, IRC §1035 lets you move the investment and gain in a life insurance policy, endowment policy or annuity contract to another policy or contract without having to pay tax on the gain. Instead, the gain carries over to the new policy or contract tax-free. This lets your customer move to a new policy or contract as circumstances or needs change. There are, of course, restrictions and rules to follow; not all policy or contract exchanges are tax-free, and not all may be suitable for the client.

Starting any time after December 31, 2009, your clients will be able to make the following exchanges that they cannot now make:

- They can exchange a life insurance policy, endowment contract or an annuity contract for a long term care insurance policy. The existing product can have a long term care insurance benefit (whether as a rider or otherwise).
- They can exchange a long term care insurance policy for another long term care insurance policy.

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Where did the December 31, 2009 date come from? We don't know.

Since tax qualified long term care contracts don't have a "cash value," how do you exchange one for another? We don't know, unless Congress was thinking of group plans which might have a reserve value. Or, perhaps the idea was that some LTCI policies could be issued with a refund of premium feature on surrender. But the refund of premium is taxable to the policyowner to the extent that the taxpayer took any deductions for premium payments. Now the policyholder won't have to worry about the extra tax burden (or the burden of figuring out the taxes owed on the past 10 years of deductions).

This change allows consumers more flexibility as their needs change over the years. A younger person could buy life insurance for those years when protection is their primary concern and annuities when future income begins to gain importance. They could even exchange their life insurance for an annuity. When the need for long term care insurance gains in importance, they will be able to take money in either the life insurance policy or an annuity and move it, tax-free, into a long term care insurance policy.

As with current rules, you won't be able to "move backwards" from a long term care insurance policy into a life insurance policy or an annuity contract.

EMPLOYER OWNED LIFE INSURANCE

We recently sent out a [bulletin](#) on the new rules the PPA added in IRC §101(j) making the death benefit from an employer-owned life insurance policy taxable unless certain rules are followed. That bulletin mentioned that a life insurance policy acquired through a 1035 exchange of a life insurance policy issued before August 17, 2006, could still be subject to §101(j). Here are some more details.

The new rules apply to policies issued after August 17, 2006, except for policies issued after that date as part of a 1035 exchange for a policy initiated before then. However, the legislation goes on to say that "any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract..." In other words, if you do a 1035 exchange after August 17, 2006, and there is a "material change" from the old policy to the new one, the new rules apply. If there is no "material change" then they don't apply.

What, exactly, is a "material increase in the death benefit or other material change"?

Buried on page 222 of the 386 page "Technical Explanation" to the PPA, prepared by the Staff of the Joint Committee on Taxation, there are a few clues.

We are told, for example, that death benefit increases required by the corridor test or the cash value accumulation test are allowed. Likewise, increases because dividends are used to buy paid-up additions are allowed, as are increases because the policy is a universal life policy with the Option B death benefit (specified amount plus cash value).

The Technical Explanation also describes other changes that won't create a "new" policy. These include "administrative changes, changes from general to separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued."

We do not know if a change in the insurance company itself is a material change that would subject an older policy to the new rules. Until a few months ago, few would have even asked this question. Then the IRS issued a private letter ruling (PLR 200627021)

that said that such an exchange is a material change for purposes of the pro rata interest disallowance rules in IRC §264(f).

As noted by the AALU in one of their recent bulletins:

Even if a change of carrier is not per se a “material change” for purposes of the new COLI rules, because insurance carriers all use different forms of contracts, and because some of the differences may have material consequences for policyholders, there will likely be uncertainty as to whether any such exchange is eligible for the exception to the new COLI rules.

WHAT DOES THIS MEAN?

If your customer is an employer and is considering a 1035 exchange of a policy bought before August 17, 2006, you should encourage your customer to treat the exchange as if it were an application for a brand new policy, and comply with all the requirements of IRC §101(j). In other words, the employer should give notice to the employee and get his consent. And make sure the policy will fall into one of the safe harbors mentioned in our earlier bulletin.

CONCERNS ABOUT FORMER EMPLOYEES AND §1035 EXCHANGES

What if the insured under the existing policy is no longer an employee? Although §101(j) applies only to current employees, some of the language in §101(j) refers to other sections of the Internal Revenue Code that do include former employees in their definitions. Remember also that your state insurable interest laws may have specific provisions relating to former employees. And that letter ruling we mentioned a moment ago? It involved a former employee. In other words, even though the insured is a former employee, there may be consequences other than §101(j) to contend with.

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