

Mechanics of an Internally Split §1035 Exchange

How to Buy LTC coverage for two people with only one policy to 1035 exchange

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Reviewing and keeping up with a client's current financial needs and goals is an ongoing process; and within that process a change of plan or products may be indicated. A common scenario that financial professionals encounter is where a client owns a life insurance policy (or policies) purchased years ago, with a cash value that has grown substantially. However, the policy no longer meets the client's needs, and the cash value within that policy could help to pay for other financial objectives, including long-term care (LTC). Using the concept of an IRC §1035 exchange can be a tax efficient way of moving cash value from an unneeded life insurance policy into another solution or solutions that makes more sense for the client's current needs.

However, the client's needs may not line up in a way that makes a §1035 exchange easy; or worse yet, the client's needs may be outside of the tax rules of a §1035 exchange. Examples of such situations might look like:


1. There is cash value from only one insurance policy, but the new goal for the cash value is to fund.....
 - an annuity to provide supplemental lifetime income, and
 - life insurance with an LTC Rider
2. There is cash value from multiple insurance policies where the client is the insured and owner, but the need is to use the cash value to purchase.....
 - a linked benefit LTC policy for the client, and
 - a linked benefit LTC policy for the client's wife

As you can see from these examples, there are a couple of challenges. Regarding the first example, not all insurance companies will do an internal split of the §1035 money once it arrives – making it impossible to purchase 2 solutions with one policy to §1035 exchange. The second example has bigger problems. There are four policies, but the client wants them consolidated into two different products – and - one of the products is for a spouse, not the insured/owner.

RULES APPLYING TO AN IRC §1035 EXCHANGE

Before continuing, it might help to go over the rules of an IRC §1035 exchange. When life insurance cash value is §1035 exchanged, it is subject to the following rules. Even if a LTC Rider is part of the policy, the exchange rules follow the base insurance product and follow the rules of "like to like". The following is required in order for a §1035 exchange to be processed:

- Owner of the new policy must be the same as the owner of the old policy. (The exception is when one of the insureds on a survivorship policy has died. The survivor can §1035 exchange the cash value to an individual policy) - AND
- Insured on the new policy must be the same as the insured on the old policy - AND
- The proper downline of allowable exchanges must be followed, as shown in the chart below

	Life Insurance	Endowment	Annuity	LTCi Policy
Life Insurance to	Yes	Yes	Yes	Yes
Endowment to	No	Yes	Yes	Yes
Annuity to	No	No	Yes	Yes

Please note that linked benefit LTC policies and LTC riders will follow the §1035 exchange rules of the base product (i.e., life insurance or annuity). Some solutions the client may need will not fit into the §1035 exchange rules. But, a large taxable event could be created for the client if they surrender the policy to obtain the cash value needed to purchase the new products.

COMMONLY PURSUED IDEAS THAT WILL NOT WORK

Financial professionals looking for the most tax efficient way to unravel a policy no longer needed, and use the cash value to meet new needs sometimes encounter challenges. We know, the rules of a §1035 exchange on life insurance requires a like-to-like transfer. But when you have two needs to cover – or worse yet – needs for two people to cover with cash value from only one policy, you can hit a snag trying to keep the transfer totally tax free. And that is where imaginative ideas can be problematic.

Two of the most common ideas that come up and should be avoided are:

1. **Withdraw the basis - §1035 exchange the gain.** One idea commonly asked about is to: first withdraw the cost basis from the life insurance cash value and use as a single premium to pay for a spouse's need such as LTC coverage – whether as a rider on life insurance or a linked-benefit policy. Then, they hope to §1035 exchange the remaining cash value (which holds all of the gain) into whatever product the insured/policy owner is looking to buy.

The assumption is that the withdrawal to the cost basis is tax free (which it normally would be on a single transaction), and that the §1035 exchange is tax free (which normally would also be true for a single transaction) – therefore, pairing the two transactions would result in accomplishing the clients goals in a tax free manner. *Unfortunately, that is not what will happen.*

Here is the problem. When both of the above transactions are performed on the same policy, a situation referred to as a “boot transaction” occurs. The result is that all of the gain in the policy will be taxed as ordinary income in the tax year the boot transaction takes place.

There is a solution, however. Depending on the products used and who the ultimate policy owner/insured will be, an *internally split §1035 exchange* may allow for all goals to be accomplished tax free, or at least minimize taxes. More to come with examples.

2. **Partial §1035 exchanges.** Another thought some financial professionals inquire about is doing a partial §1035 exchange out of the life insurance policy into a different life insurance based policy (often times with an LTC Rider), or into a linked benefit LTC policy, or into an annuity for lifetime income. The old policy may be rich with cash, and it is hoped that some of the cash value can be used from the old policy to fund a new product that can help meet their current goals. They may even reduce the death benefit on the old policy (with care not to create a material change in the contract that would create a modified endowment contract [MEC]).

Here is the problem. While annuity rules allow for partial §1035 exchanges, nothing in the tax code mentions the ability to do partial §1035 exchanges with life insurance. Therefore, most insurance companies will not process such transactions. However, an *internally split §1035 exchange* might be able to address the new goals the client has in mind.

WHAT IS AN INTERNAL SPLIT §1035 EXCHANGE?

An internal split §1035 exchange is a process where 100% of the cash value from a life insurance policy (or policies) is §1035 exchanged to another insurance company that offers all of the products the client needs. Upon receipt of the funds, the new insurance company “splits” the dollars into amounts needed to purchase the new policies. There are a couple of ways an internally split §1035 exchange may help a client accomplish their goals with the use of cash value from unneeded policy or policies.

HOW DOES AN INTERNAL SPLIT §1035 EXCHANGE DIFFER FROM A PARTIAL §1035 EXCHANGE?

The difference between a partial §1035 exchange and an internally split §1035 exchange is that with the internal split §1035 exchange, all of the cash value is exchanged from Insurance Company A over to Insurance Company B – so no partial transfer exists. Only when Insurance Company B has received 100% of the exchange money from Insurance Company A, is the cash value split up for use among various insurance products (including annuities) that are all issued by Insurance Company B. In addition, the §1035 funds will be allocated to each product with a pro-rata split of cost basis and gain. And because the entire amount of value has been transferred in the §1035 exchange, there has been no taxable boot transaction.

Internal Split §1035 Exchange Example #1 – One owner/insured with Needs for Two Individuals

1. A life insurance policy (or several policies) is §1035 exchanged in full (100%) to another insurance company
 - a. It is important that the new insurance company offers all of the insurance products the client wishes to purchase to meet their new goals.
2. Once the cash value has been transferred from the old insurance company over to the new insurance company, the cash value is “split” internally by the receiving company into as many portions as needed to buy the new products.
 - a. Traditionally the split is into two, or sometimes three different insurance products
 - b. The cost basis and gain is also applied pro-rata to each portion of cash value used to purchase each product.
3. Remember that when §1035 exchanging cash value to the new products, it must be done in a like-to like manner.
 - a. For the original owner/insured, this should not create a problem
 - b. But when the goal is to use some of the §1035 exchanged funds to pay for a product for the benefit of the spouse – it will require an additional purchase.
 - i. Some of the §1035 exchange dollars can be split out and §1035 exchanged into a non-qualified single premium immediate annuity (SPIA). The original life policy insured/owner will be the annuitant and owner of the new SPIA. The income generated from the SPIA can help purchase a product for another person - usually the spouse. The income paid from the annuity is not connected to the §1035 exchange, and can be used for any purpose, including buying a policy for a spouse.
 1. The §1035 exchange from the life insurance cash value to the SPIA is a tax free transaction. However, the income paid out from the annuity will be taxed based on annuity rules (gain out first).
 2. However, the taxes may be minimized since they will be stretched out and paid annually according to the pay-out period used to purchase the spouse's policy (i.e. 10 years).

Internal Split §1035 Exchange Example #2 – Consolidate and Repurpose

Another form of a split §1035 exchange is when a client has numerous policies they are looking to consolidate into new more relevant products. For example, a client may own four life insurance policies from four different carriers with varying amounts of cash value. None of the cash value amounts, no matter how combined, will add up to the correct amount needed to purchase the two new policies. The following process would apply:

1. All of the policies being §1035 exchanged must match in name of owner and insured
2. All of the policies are §1035 exchanged over to the new insurance company. Once the cash value from all the insurance companies has arrived to the new insurance company, the cumulative amount of §1035 funds received can be split into the correct amounts of funding needed to purchase the new insurance and/or annuity products.
3. If there is a need to buy policies for someone other than the owner/insured of the original policies, then the additional steps described above using a non-qualified SPIA would be used.

CASE STUDIES

Keep in mind that not all insurance companies will do an internally split §1035 exchange, so it is important that the financial professional use a carrier that offers all of the products the client is looking to purchase to meet their new needs. The following are examples of solutions a client may be trying to achieve with one (or multiple) life insurance policies issued to and owned by only one party of a couple. We are going to assume that the insurance policies are on the male spouse.

Case Study #1

Joe and Jane are in their early 60's. Joe owns a life insurance policy with \$200,000 of cash value of which \$80,000 is cost basis. His insurance needs have reduced substantially - and at this point, he is more concerned that they protect their retirement portfolio with some form of long-term care (LTC) coverage. However, Joe would still like to keep some life insurance coverage, so it is decided that an indexed Universal Life (IUL) Insurance policy with an LTC Rider would be the appropriate product for him. Jane is more concerned that she have quality LTC coverage with inflation, so they will also buy a linked benefit LTC policy for Jane using a 10 year premium schedule.

1. \$100,000 of the §1035 exchange dollars will be used to purchase Joe his IUL policy with the LTC Rider. His pro-rata allocation of cost basis/gain will be \$40,000 of cost basis and \$60,000 of gain. Since this is a “like to like” exchange, both as insured and policy owner, this transaction will meet the requirements for a §1035 exchange.

2. The remaining \$100,000 will be §1035 exchanged into a non-qualified SPIA, which will be set up with a 10-year term certain income stream. His cost basis will be \$40,000, and the gain will be \$60,000. Since the exchange is “like to like”, both as insured/annuitant and policy owner, this transaction will meet the requirements for a §1035 exchange - since life insurance qualifies to be §1035 exchanged into an annuity.
 - a. The annual income will provide the amount needed to pay the premium for Jane’s linked benefit LTC policy. Note that the income coming from the SPIA is not part of the §1035 exchange, therefore it can be used to pay for Jane’s linked benefit LTC policy.
 - b. The insurance company may offer a streamlined process that will allow for an internal transfer of the annuity income to pay the premium for the linked benefit LTC policy.
 - c. The annuity income will be subject to taxation based on an exclusion ratio – in this example, 40% is tax free and 60% is taxable. Processes for withholding taxes on the income will vary (check with the carrier for options).

Case Study #2

Sue is 59 years old and a recent widow. Her husband, Sam, just passed away at age 62. There was no life insurance on Sam due to his being uninsurable for many years, but they did have permanent accumulation life insurance on Sue. Her life insurance policy currently has \$180,000 of cash value with a cost basis of \$60,000. Now that her husband has passed and her children are grown, Sue and her financial professional feel that the cash value could be put to better use. Sue would like LTC coverage; and though her financial professional feels that Sue is in fairly good financial shape for retirement, buying an annuity to provide some supplemental guaranteed income later in life might be wise to have, to buffer unexpected high inflation or a downturn in her income producing portfolio. Thus, the \$180,000 will be §1035 exchanged to a new life insurance company, where the cash value will be internally split to accommodate a §1035 exchange into both a linked benefit LTC policy and a deferred annuity with guaranteed lifetime income.

1. To fund the LTC coverage, \$75,000 of the §1035 dollars will be exchanged into a linked benefit LTC policy with 3% compound inflation and a 6-year LTC benefit pool. The cost basis will be \$25,000. Her LTC benefit pool will start at \$220,000, but by age 80, she will have \$442,000 – paying \$6,138 a month tax free. By age 85, she will have \$512,000 in her benefit pool that would pay \$7,111 in tax free LTC benefits. If she never needs care, the \$75,000 death benefit will be paid tax free to her beneficiaries.
2. The remaining \$105,000 of the §1035 exchange will be used to purchase a deferred variable annuity that offers Sue guaranteed lifetime income. The cost basis will be \$35,000. The \$105,000 will grow tax deferred. If Sue never needs to turn on the income, the value of the annuity will be paid as a death benefit to her beneficiaries – and will be taxed according to annuity rules. If she ever decides she could use more income, Sue will be able to turn on a guaranteed income stream that will last the rest of her life. Any contract value left at her death (if any) will be paid to her beneficiaries and taxed according to annuity rules.

INTERNALLY TRANSFERRED QUALIFIED DOLLARS

Some clients will have money in 401(k) or IRA accounts that they would like to use to purchase long-term care coverage. Unfortunately, neither LTC riders on life insurance, linked benefit LTC policies, nor traditional LTC policies can be owned inside of a qualified plan. One solution would be to transfer 401(k) dollars into an IRA. From there, those dollars could be used to purchase an IRA Single Premium Immediate Annuity (IRA SPIA). The insurance company can internally split the transferred funds, and can be used to help a variety of multiple objectives such as:

- 1) 401(k) dollars could be directly transferred into a traditional IRA. From there, the IRA dollars could be transferred to an insurance company. The IRA dollars would be internally split and could purchase for example:
 - a) An IRA SPIA that would provide the income needed to fund the premiums for a linked benefit LTC policy, AND
 - b) A deferred IRA annuity for purposes of guaranteed income

Funds from one spouse’s IRA could be transferred to an insurance company to purchase an IRA SPIA. The income could then be split in order to purchase linked benefit LTC policies for each spouse. The insurance company may also have capacity to do the income split internally and offer a seamless internal process of having annuity income pay the linked benefit LTC policy premiums. Keep in mind that annuity payments funding the linked benefit policies would be taxable as traditional IRA income. Term certain payouts to owners under the age of 59½ do not comply with IRC Section 72T because payments are not based on life or life expectancy, therefore will be subject to the 10% penalty.

SUMMARY

With careful thought and planning, there are many opportunities to use §1035 exchange dollars to fund the changing needs of your clients. Moreover, an internally split §1035 exchange offers further opportunities to use such dollars to implement multiple solutions while maintaining proper §1035 exchange rules. While taxes can't be totally avoided when planning for the non-policy owner (spouse), taxation can be minimized. More importantly, a split §1035 exchange leaves the door open to potentially use cash value in unneeded policies vs. using new money to meet the need of the client and their spouse.

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