

IRS determines that exchange of life insurance policies qualifies as tax-free

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In brief

In PLR 201304003, the IRS concluded that the exchange by an irrevocable trust of one life insurance policy for another qualifies as a like kind exchange under section 1035.

In detail

Old Issuer, a life insurance company issued to “Old Trust” a joint and survivor policy on the lives of husband and wife (A and B). A subsequently died leaving B as the sole insured. After A’s death, the policy was transferred to “New Trust,” which was created with the consent of all beneficiaries of the Old Trust. The trustee of New Trust then exchanged the “Old Policy” for a new life insurance contract covering only B’s life.

Under section 1035(a)(1), no gain or loss is recognized on the exchange of one life insurance contract for another. To be considered a “life insurance contract,” a contract must satisfy the requirements of section 7702(a). Additionally, the contract must satisfy the definition of that term in section 1035(b)(3), which defines a “contract of life insurance” as a contract with an insurance company that depends in part

on the life expectancy of the insured, but that is not ordinarily payable in full during the life of the insured. The legislative history of section 1035 indicates that Congress viewed nonrecognition treatment as appropriate for “individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain.”

New Trust’s assignment of Old Policy to New Issuer and receipt of New Policy qualifies as an exchange of one contract of life insurance for another contract of life insurance under section 1035(a)(1).

In concluding that the exchange qualified as a like kind exchange under section 1035(a)(1), the IRS noted that at the time of the exchange, the sole remaining insured on Old Policy was B. The sole insured on New Policy was also B. Thus, the exchange did not involve a change of insured. A change of insured

would have disqualified the transaction from nonrecognition treatment under section 1035.

The takeaway

PLR 201304003 reached a practical result, and made it clear that the eligibility of an exchange for the benefits of section 1035 is determined on the basis of facts that are available at the time of the exchange. To conclude otherwise would have made it impossible to ever exchange a joint and survivor policy after one of the insureds has died.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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