



SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2013 – Volume 9 Issue 2

neither the insured nor the beneficiary wants the contract to terminate by virtue of an actual distribution. This approach would seem to be particularly helpful in the context of GLWB riders covering the joint lives of two individuals who are not spouses, *e.g.*, siblings, couples who live together but choose not to marry, and same sex couples who may be partners to a civil union or enjoy status as spouses under state law but not federal law.⁵ ◀

not relate to the same insured.”² As explained below, the IRS in PLR 201304003 concluded that the exchange satisfied this “same insured” requirement in the regulations and qualified for nonrecognition treatment under section 1035.

FACTS

A husband and wife (A and B) purchased a second-to-die life insurance contract (Old Policy), which provided for the payment of a death benefit equal to a specified amount (\$X) upon the death of whichever spouse was the last to die. Old Policy was a life insurance contract under sections 1035(b)(3) and 7702. The couple transferred the contract to an irrevocable trust that they established (Old Trust).

One spouse (A) later died, leaving the surviving spouse (B) as the sole insured under Old Policy. B subsequently transferred Old Policy to a new irrevocable trust (New Trust) settled by B, with the consent of all the beneficiaries of Old Trust, in accordance with the requirements of state law. New Trust was the owner and sole beneficiary of Old Policy.

The trustee of New Trust exchanged Old Policy for a new life insurance contract (New Policy) under which New Trust was the owner and sole beneficiary, B was the sole insured, and the death benefit was equal to \$Y. New Policy was a life insurance contract under sections 1035(b)(3) and 7702. The exchange was accomplished by New Trust assigning its interest in Old Policy to the issuer of New Policy, the new issuer issuing New Policy to New Trust, and the new issuer then surrendering Old Policy.

ANALYSIS AND CONCLUSION

In applying section 1035 to the exchange of Old Policy for New Policy, the IRS in PLR 201304003 considered (1) whether Old Policy and New Policy were life insurance contracts to which section 1035 applied, and (2) whether the exchange was one which qualified for nonrecognition treatment under that section.

- The IRS indicated generally that in order for Old Policy and New Policy to be contracts subject to section 1035, they must satisfy both section 7702 (which defines a “life insurance contract” for purposes of the Internal Revenue Code) and section 1035(b)(3) (which defines a “contract of life insurance” for purposes of section 1035).³ Based on representations made by New Trust, the IRS was comfortable that Old Policy and New Policy satisfied these sections.

END NOTES

- ¹ The rulings were issued on July 13, 2012, and were released to the public on Jan. 11, 2013. The rulings appear to have been issued to affiliated life insurance companies.
- ² Section 72(s) distributions are triggered by the death of any contract “holder,” which generally means any owner. If an owner dies on or after the annuity starting date, any remaining interest in the contract must be distributed at least as rapidly as the method of distribution being used on the date of death. Section 72(s)(1)(A). If an owner dies before the annuity starting date, any remaining interest in the contract must be distributed within five years of the owner’s death or over the life or life expectancy of a designated beneficiary starting within a year of the owner’s death. Section 72(s)(1)(B) and (2).
- ³ Section 72(s)(3).
- ⁴ See Treas. Reg. section 1.451-1(a).
- ⁵ See Defense of Marriage Act, 1 U.S.C. § 7 (defining “spouse” for purposes of federal law as “a person of the opposite sex who is a husband or a wife”).

APPLYING SECTION 1035 TO A POST-DEATH EXCHANGE OF A SECOND-TO-DIE LIFE CONTRACT

By Mark E. Griffin

In January, the Internal Revenue Service (IRS) released PLR 201304003, which addressed the application of section 1035 to the exchange of a survivorship, or “second-to-die,” life insurance contract after the death of one of the insureds for a new life insurance contract covering only the life of the surviving insured.¹ Section 1035(a)(1) provides that no gain or loss will be recognized on the exchange of a “contract of life insurance” for another “contract of life insurance.” In addition, the regulations state, in part, that section 1035 does not apply “if the policies exchanged do

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- In determining whether the exchange qualified for non-recognition treatment under section 1035, the IRS looked primarily to the same insured requirement in the regulations under section 1035. Notwithstanding that spouses A and B originally were the insureds under Old Policy, the IRS focused on the fact that at the time of the exchange, surviving spouse B was the sole remaining insured under Old Policy and the sole insured under New Policy. Based on this fact, the IRS determined that the same insured requirement in the regulations was satisfied in this case.

Accordingly, the IRS ruled that the exchange of Old Policy for New Policy qualified for tax-free treatment under section 1035, so that New Trust did not recognize any gain or loss on the exchange.

OBSERVATIONS

The facts and the IRS' reasoning in PLR 201304003 are similar to those in earlier private letter rulings. In particular, the IRS also determined in PLR 9330040 and PLR 9248013 that nonrecognition treatment under section 1035 applied to the exchange of a second-to-die life insurance contract after the death of one of the insureds for a new life insurance contract covering only the life of the surviving insured. It is noteworthy that all three of these private letter rulings include a caveat that the IRS expressed no opinion on whether section 1035 applies to the exchange of a second-to-die life insurance contract prior to the death of either of the insureds for a life insurance contract insuring a single life. However, the IRS in PLR 9542037 expressed the view that the same insured requirement was not satisfied, and thus that section 1035 nonrecognition treatment did not apply, in several situations involving exchanges of one or more single life insurance contracts for second-to-die life insurance contracts. Based on this view, it would seem unlikely that IRS would apply nonrecognition treatment under section 1035 to the exchange of a second-to-die policy while both insureds are alive for a life insurance contract covering only one life. ◀

END NOTES

¹ The private letter ruling was issued on Oct. 15, 2012, and was released to the public on Jan. 14, 2013.

² Treas. Reg. section 1.1035-1(c).

³ A "contract of life insurance" is defined in section 1035(b)(3) generally as a contract with a life 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. In addition, section 7702(a) sets forth the definition of a "life insurance contract" for purposes of the Internal Revenue Code.