The Lure of Exchanging Annuities

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From October 2002 through mid 2007, the United States enjoyed a prosperous bull market. Accordingly, the stock market introduced an array of new investment products to meet the demands of investors. One particular benefactor of the past bull market was issuers of variable annuities and variable life insurance products. In 2006, variable annuity sales, alone, increased by nearly 35%, reaching a high of nearly $185 billion in sales. Consequently, issuers of these products are continually creating new features to compete in this highly competitive market, such as providing optional income protection/principal protection riders.

For those that are considering exchanging their annuity or life insurance policy for a new contract, the Internal Revenue Code ("IRS") provides a tax-free incentive. Under IRS Code Section 1035, an investor may transfer assets from one annuity or life insurance contract to another without any negative tax implications. A 1035 exchange provides favorable tax treatment for the following exchanges: a life insurance contract for a non-qualified annuity contract, endowment contract or another life insurance contract; an endowment insurance contract for a non-qualified annuity contract or another endowment contract; or an annuity contract for another annuity contract.

The deferral of gains from the original contract to the new contract is often the primary reason for effectuating a 1035 exchange. However, exchanging an annuity or life insurance contract may also include lower costs, more flexibility and greater investment choices, or additional features and insurance guarantees. With the cessation of the bull market and onset of the pending recession, many investors are opting for new products with new "bells and whistles." The uncertainties with the market have led many investors to the promises of guaranteed income and protection of principal associated with many variable products. LIMRA estimates that over 80% of new variable annuity sales involve elections for guaranteed riders. For others, the idea of exchanging their variable product for a fixed product is a more attractive alternative.

In addition to new features, owners of certain insurance contracts have an added incentive to consider a 1035 exchange. In cases where the adjusted basis of the contract exceeds the current cash value, a 1035 exchange preserves the adjusted basis of the old policy. Consider the example of an insured that purchased an insurance policy 10 years ago, paid $1,000 in annual premiums, received $3,000 in dividends, and has a current cash balance of $5,000. The adjusted costs basis in this scenario is $7,000 ($10,000 in premiums less $3,000 in dividends). If the insured surrenders the contract and purchases a new contract with the cash value, the basis in the new contract would be $5,000. On the other hand, an exchange would preserve the original basis of $7,000 with the new contract.

Regardless of the reason, the decision to exchange an annuity or life insurance contract involves implications that are often overlooked. For one, depending upon the product and the original purchase date, the client may have to pay early withdrawal penalties, surrender charges, or contingent deferred sales charges upon effectuating an exchange. Most variable annuities and variable universal life insurance policies contain surrender charges which expire or decline over time. Also, the new product will probably contain similar charges. Consider the example of a client that purchases a variable annuity two years ago for $100,000, with an accompanying surrender period of 5 years. The variable annuity is currently worth $105,000 and the current surrender charge is 6% (or $6,300). The new annuity carries a ten year surrender period. Depending upon the age of the client and their respective liquidity needs, the exchange may not be in their best interest.

Another component of a 1035 exchange that is often overlooked is the resulting tax implication. Any amount withdrawn but not exchanged will generally be subject to ordinary income tax. If the investor is not yet 59 ½ , an additional 10% tax penalty may also apply. Also, to preserve the tax deferral feature, a non-qualified annuity can only be exchanged for another annuity that has the same owner and annuitant, and the owner of an insurance contract is also not permitted to change the ownership or the insured during the 1035 exchange.

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In the particular case of insurance policies, if the customer's health condition has changed, additional premiums may apply and/or certain coverage issues may arise with the new policy.

Particular attention should also be paid to contracts containing "market rate adjustment" provisions. In these cases, the proceeds from an exchange may be lower that in an immediate surrender.

In some cases, the contract owner only wishes to exchange a portion of the current contract for a new contract. In the case of Conway v. Commissioner, 111 T.C. No. 20 (1998), the Tax Court approved the application for 1035 exchanges in cases of partial exchanges so long as the facts indicate that the exchanged funds were reinvested in a contract which would have qualified for 1035 treatment if the entire original contract had been exchanged. In 1999, the IRS issued an Action on Decision acquiescing to the Tax Court's ruling. However, the IRS is aware of the opportunity for abuse. The IRS cited for example a situation where contract owners enter into a series of partial exchanges as a part of a plan to avoid adverse tax consequences under Section 72 of the IRS Code. Most recently, the IRS proposed a presumption of abuse in situations where withdrawals are taken within two years of partial exchanges. Therefore, although permitted, the IRS is strictly scrutinizing the tax treatment of partial 1035 exchanges.

In closing, Section 1035 exchanges continue to afford many investors an opportunity to upgrade their existing annuity or insurance contracts. However, whether considering a partial or full exchange of an annuity or insurance contract, the replacement of one contract for another should be justified and in the best interest of the investor. These decisions should also only be made after obtaining adequate and competent tax advise.

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