A New Opportunity for 1035 Exchanges?

For a 1035 exchange to occur, does the owner of the contract have to be living?

Maybe, maybe not.

For decades, the IRC 1035 exchange option has been used to transfer non-qualified annuity contract values from carrier to carrier. In this common process, the owner of an existing contract applies for a new contract, exchanging all or some of the existing cash value present in the old contract into the new contract. The transfer must occur carrier to carrier. The owner on the old contract and the new contract must remain the same.

When the owner of a non-qualified annuity contract dies during the accumulation period (that is, the contract has not annuitized), unless there is a special contract provision for annuitant to step into the role of owner, the rights of the beneficiary come into play. Depending on the relationship between the deceased owner and the beneficiary, the payouts of inherited contract values must occur within IRC-mandated timeframes. These timeframes include a five-year option (contract fully liquidated at end of 5 years) and a life expectancy option (based on the life expectancy of the beneficiary).

Prior to July 26, 2013, the common understanding regarding 1035 exchanges was that the right to invoke one disappeared with death of the owner. This meant the beneficiary was stuck in the original contract at the original carrier previously selected by the deceased. If the contract was unattractive for whatever reason – poor performance, bad ratings, or unattractive loads – it was too bad for the beneficiary who was required to liquidate the payouts from within the original contract.

So what does this mean? Beneficiaries may have some ownership rights of the deceased owner.

As of July 26, 2013, in a private letter ruling – PLR201330016 – the IRS determined that some of the owner's rights were inherited by the beneficiary and one of those rights was to achieve a 1035 exchange.

So what does this mean? A private letter ruling cannot be relied upon as general processes for all contract owners. It demonstrates, however, the direction of regulatory thinking. From an administrative viewpoint, it means you need to start thinking about new possibilities in day-to-day operations:

- You should prepare to see new business applications among the many 1035 exchanges being initiated by a beneficiary moving an asset.
- It will require that the asset be titled correctly, e.g. John Doe Deceased for benefit of Mary Doe
- It will mandate that normal course of processing against a new business contract – such as allowing new money contributions, taking loans, requesting assignments -- will be prohibited against the inherited annuity contract.
- It means that the payout rules for 5-year or life expectancy need to be set up immediately as part of the contract establishment process.

Of course, your legal department must opine on this topic. Expect that the new exchange rights of beneficiaries might soon translate into new processing rules for your new business operations.

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