# Understanding the **1035 exchange**

When exchanging or keeping a contract makes the most sense

Allianz Life Insurance Company of New York
Allianz Life Insurance Company of North America

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# Should I keep or exchange my contract?

If you own a nonqualified deferred annuity contract or a cash value life insurance policy, you may wonder if you should switch to a new contract or policy at some point. You should always evaluate the features and benefits of your existing contract or policy before you make any changes. If you and your professional advisors decide that it makes good sense to change to a new contract, a 1035 exchange does not result in a taxable event, which can be a significant benefit for you.

If you currently own a nonqualified deferred annuity contract or a cash value life insurance policy, there may be provisions in that contract or policy that are very favorable to you. The contract may have strong guarantees or an expired surrender charge period, for example. On the other hand, the contract could be missing newer features such as an increasing death benefit or a rider that is more attractive to you. Because every situation is different, there is no quick answer to the question of whether you should keep your existing contract or exchange it for a newer one. Your financial and tax professionals can help you with that question.

## Tax results of 1035 exchanges

When evaluating the issue of whether to keep or exchange the contract, you must consider the tax results. When you dispose of one asset (like stocks or real estate) to buy another, you usually have to report your gain or loss on your tax return – and pay income taxes if there is a gain in the asset's value.

But nonqualified deferred annuities and cash value life insurance policies are different. Through a provision in the Internal Revenue tax code, you can exchange a nonqualified deferred annuity or a life insurance policy for a nonqualified deferred annuity contract, or a life insurance policy for another life insurance policy – without having to report the first contract or policy's gain or loss – as long as you meet certain requirements.

In other words, if handled properly, the exchange is income-tax-free. The new contract or policy will simply assume the "basis" (see sidebar) of the old contract or policy. We call this a 1035 exchange, after the section of the Internal Revenue Code that allows it.

## When might you consider a 1035 exchange to a nonqualified annuity?

Here are a few situations in which a 1035 exchange to a nonqualified deferred annuity may be appropriate:

- You have owned a nonqualified deferred annuity for some time, but now want to switch to a new nonqualified deferred annuity that provides improved features.

### What is "basis"?

Basis is the amount you paid into the contract – in other words, your premium payment(s). When you take distributions from the contract, you will pay income taxes only on the gain the contract has earned over the basis. Distributions from life insurance and annuities may be taxed differently, so discuss your situation with your tax advisor.

- You own a life insurance policy you no longer need, and you want to exchange it for a nonqualified deferred annuity that gives you the opportunity for lifetime income.

**But before you cancel your current contract or policy, be sure you understand any benefits you may be giving up, any surrender charges you may incur, and your present health situation for insurability issues. Discuss these with your financial professional before making a decision.**

## 1035 exchange requirements

There are several requirements you must meet to have your transaction qualify as a tax-free 1035 exchange.

If you follow these rules, the exchange of contracts should be **INCOME-TAX-FREE**, and the new contract will CARRY OVER THE BASIS AND HOLDING PERIOD FROM THE OLD CONTRACT.

Rule 1: You have to exchange the right kinds of contracts. You can exchange:

- a cash value life insurance policy for another cash value life insurance policy, nonqualified deferred annuity contract, or qualified long term care insurance policy
- a nonqualified deferred annuity contract for another nonqualified deferred annuity contract or a qualified long term care insurance policy
- a qualified long term care insurance policy for another qualified long term care insurance policy

Please note: You **cannot** do a tax-free exchange of a nonqualified deferred annuity for a life insurance policy. You also **cannot** do a tax-free exchange involving an annuitized nonqualified annuity.

Rule 2: The owner has to be the same for both the old contract and the new contract. The annuitant (or the insured person, if life insurance is involved) must also be the same party on the old and new contracts or policies.

While the parties must align during the exchange, you may be able to change parties either before or after the exchange, depending on the insurance company and/or the products.[1] Please be aware that changing parties may result in a taxable event.

For example, let's suppose Julia owns a nonqualified deferred annuity in her own name and wants to exchange to a nonqualified deferred annuity owned jointly by herself and her husband Charles. She can either:

- add Charles as joint owner prior to the transfer and exchange the annuity for a new contract in their joint names, or
- exchange the annuity in her own name, then add Charles as joint owner after the exchange.

Spouses can change ownership of a nonqualified deferred annuity or life insurance policy between themselves without tax consequences. However, if you change ownership to someone other than your spouse, there may be gift and income tax consequences.

### 1035 exchange: a hypothetical example

Let's take a look at how a 1035 exchange might work. Suppose Jessica bought a nonqualified deferred annuity in 1999 for $100,000. Its current value is $120,000, and the contract is no longer subject to surrender charges.

Jessica recently found a new nonqualified deferred annuity that better suits her needs, and she has decided to exchange her old contract for the new annuity. The old company will send a check for $120,000 directly to the new company. The new contract will have the same $100,000 basis as the old contract, despite having a value of $120,000. If Jessica followed the 1035 exchange rules, she does not have to pay tax on the $20,000 gain at this time.

[1] Please note that Allianz Life Insurance Company of North America (Allianz) and Allianz Life Insurance Company of New York (Allianz Life® of NY) accept only single annuitants, not joint annuitants. If you own a contract that currently has joint annuitants, you must change it to one annuitant prior to the exchange into a new Allianz or Allianz Life of NY nonqualified annuity contract. If you cannot drop the second annuitant, you will not be able to exchange to an Allianz or Allianz Life of NY nonqualified deferred annuity.

The example is for illustrative purposes only and does not represent an actual client.

Rule 3: There is no 60-day rollover opportunity for transferring nonqualified deferred annuity contracts, as there is with IRAs and other tax-qualified arrangements. The 1035 exchange must be made directly from one insurance company to another. Your financial professional can help facilitate this.

## Partial 1035 exchanges with an annuity

You are also allowed to exchange part of a nonqualified deferred annuity for a new nonqualified deferred annuity income-tax-free. This is called a "partial exchange." If you make a partial exchange, the basis is prorated between the old contract and the new contract.

It's worth noting that the IRS has historically been wary of partial exchanges of nonqualified deferred annuities, because of the potential to abuse the tax rules. For example, someone could split contracts, and take a distribution from one to reach income-tax-free basis more quickly than if the annuity had remained whole.

To address this possibility, the IRS has stated that if you make a partial 1035 exchange, **you cannot take a distribution from either the old annuity or the new one for 180 days.** If you do take a distribution within 180 days, you risk having the exchange treated instead as a taxable distribution. However, you are allowed to annuitize one or both of the contracts immediately over a period of 10 years or more (or over your life expectancy).

### Partial exchange: a hypothetical example

Let's again consider Jessica, who owns a nonqualified deferred annuity contract with a $120,000 value and a $100,000 basis. Suppose she only wants to move half of it to a new annuity. The original company will send a check for $60,000 to the new company. Now Jessica will have two contracts, each with a $60,000 value and a $50,000 basis. To avoid paying income taxes on the exchange, she should not take a distribution from either contract for at least 180 days.

## If your contract has lost value

If your old annuity contract has a gain, you will likely want to do a 1035 exchange to avoid recognizing the gain. But if your old contract is "underwater" – if its current value is less than your basis in the contract – you have some additional choices:

1. You can keep the contract and wait to see if it performs as you'd hoped.
2. You can surrender the annuity contract, and not do an exchange. This may allow you to recognize the loss on your income tax return by treating it as a miscellaneous itemized deduction (subject to a floor of 2% of adjusted gross income (AGI), as long as you purchased the annuity for profit). Keep in mind that surrender charges can be incurred. Also note that the loss on a life insurance contract is not deductible.
3. Or, you could do the 1035 exchange. In that case, the basis from your old contract is carried over to the new contract, and there would be no tax liability on distributions from the new contract until the value of the new contract grew to exceed the basis amount.

### Itemizing a loss: a hypothetical example

Jason put $300,000 premium (basis) into a nonqualified deferred variable annuity. The contract is now worth only $270,000 after a downturn in the stock market. Jason wants to replace this annuity with a newer annuity with more attractive features. He can surrender the contract, recognize the $30,000 loss as a miscellaneous itemized deduction, and then buy the new annuity. Keep in mind that surrender charges can be incurred. Or, he can exchange the $270,000 variable contract for the new annuity. The new annuity will take over the $300,000 basis. The contract can grow back up to $300,000 without any tax consequences.



These examples are for illustrative purposes only and do not represent actual clients.

## Other points to consider

- The rule that you "tack" the holding period when you do a 1035 exchange can be important if you are trying to qualify for the "immediate annuity" exception for the 10% federal additional tax for distributions before age 59½. The IRS considers an immediate annuity as one where the payments begin within one year of the purchase. If you exchange a nonqualified deferred annuity into a product called an immediate annuity, you likely will not qualify for the exception to the 10% federal additional tax because the payments likely will not begin within one year from the purchase of the first contract.

- If you own a life insurance policy and are thinking about exchanging it for an annuity, you should first consider your health. If you are older or in poor health, it is generally not a good idea to give up your life insurance. On the other hand, if you are healthy, don't need the life insurance, and are looking for lifetime income benefits, you could consider exchanging the life insurance policy for a nonqualified deferred annuity.

- Be cautious if you are exchanging a life insurance policy with an outstanding loan for a new nonqualified deferred annuity. Most insurance companies will not issue a new annuity contract with a loan on it. Therefore, the loan would have to be terminated first by the old insurance company from existing cash values, and then the life insurance policy would be exchanged into the new annuity without a loan on it. The IRS considers this loan termination as taxable "boot" when it is part of an exchange, and you would have to pay income taxes on the loan amount to the extent the life insurance cash value transferred plus the outstanding loan amount exceeds the cost basis in the life insurance policy.

- Sometimes a life insurance policy's cash value will be less than the premiums paid into it. If you surrender that life insurance policy, the loss is not income-tax-deductible. The rule is different for variable annuities, however, and the loss should be tax-deductible if the annuity was entered into for a profit (subject to a floor of 2% of AGI). If you exchanged that life insurance contract for a new annuity, and then surrendered the new annuity shortly thereafter, it is unlikely that you could tax-deduct the loss, because in order to tax-deduct the loss, the length of time you owned the new annuity must show an intent to enter into it for a profit.

- Please note: Allianz and Allianz Life of NY will not allow you to 1035 exchange an annuitization payment or an income benefit payment from an existing nonqualified annuity to a new nonqualified annuity contract.

Exchanging an existing annuity or life insurance policy into a new nonqualified deferred annuity contract can offer some benefits, but requires careful review. **Before making a decision, talk to your tax advisor and your financial professional about the advantages and disadvantages of a 1035 exchange.**

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As leading providers of annuities and life insurance, Allianz Life Insurance Company of North America (Allianz) and its subsidiary, Allianz Life Insurance Company of New York (Allianz Life® of NY), base each decision on a philosophy of being true: **True to our strength** as an important part of a leading global financial organization. **True to our passion** for making wise investment decisions. And **true to the people we serve**, each and every day.

Through a line of innovative products and a network of trusted financial professionals, Allianz and Allianz Life of NY together help people as they seek to achieve their financial and retirement goals. Founded in 1896, Allianz, together with Allianz Life of NY, is proud to play a vital role in the success of our global parent, Allianz SE, one of the world's largest financial services companies.

While we pride ourselves on our financial strength, we're made of much more than our balance sheet. We believe in making a difference with our clients by being true to our commitments and keeping our promises. People rely on Allianz and Allianz Life of NY today and count on us for tomorrow – when they need us most.



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