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Section 1035: The Gray Areas of Policy Exchanges

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Abstract: *The most important question about last survivor policies in connection with Section 1035 is whether a person should be permitted, on a tax-deferred basis, to exchange a single life policy upon the person's life for a survivorship policy on the life of the person and the person's spouse. The reasoning used by the Internal Revenue Service in its rulings on related, but different, questions suggests that such an exchange should not be permitted. However, there are strong policy arguments that favor protecting such an exchange under Section 1035, and a favorable result may be reached under current law without reversing any precedent. After analyzing this question in detail, the article discusses other questions about Section 1035 exchanges which are of current interest.*

The issues involved in the tax effects of various Section 1035 exchanges can be divided into categories according to the nature of the transaction. This article has been divided into sections to facilitate discussion of those issues.

Last Survivor Policies

The most important issue is whether a client can exchange a single life policy on the client's life for a last survivor policy on the life of the client and the client's spouse. Section 1035 of the Internal Revenue Code of 1986 ("Code") allows the exchange of a life insurance policy for another policy without the recognition of taxable gain under specific circumstances.[1] The purpose of Section 1035 is to prevent the taxation of individuals "who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain."[2]

Although the Code itself does not require it, the Treasury Regulations ("Regulations") require that the new policy relate to the "same insured" as the old policy.[3] Whether the "same insured" requirement is met for an exchange to a last survivor policy, and whether it should be required in the first place, is discussed below. This precise issue has not been addressed by the Internal Revenue Service or by any court.

In Revenue Ruling 90-109,[4] the Service addressed the question of sameness where the life insurance policy stayed the same, but the insured was changed. The policy in question had an option allowing the corporate policyowner to change the insured under a key man policy. In this instance, the Service ruled that a taxable exchange had occurred, and that Section 1035 was not applicable.

The reasoning was that the change of insureds "resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract." The Service explained that the purpose of the "same insured" Regulation is to prevent "policyowners from deferring indefinitely recognition of gain with respect to the policy value" by changing insureds.

The question addressed in Revenue Ruling 90-109 would not appear to be important for an exchange of a single life policy to a last survivor policy. But this Revenue Ruling is important because of the comments made by the Service in reaching a conclusion. The Revenue Ruling shows how the Service is thinking when it comes to analyzing a Section 1035 transaction. In addition, because it is a Revenue Ruling, it has general application to all taxpayers.[5]

If the reasoning of this Revenue Ruling is applied to the exchange of a single life policy for a last survivor policy, the exchange probably would be prohibited. By adding an additional insured, the Service may find that the essence of the life insurance contract has changed. Certainly a contract insuring one life (with death proceeds paid when that life ends) is fundamentally different than a contract insuring two lives (with death proceeds payable only after the death of both lives). Under the reasoning of Revenue Ruling 90-109, this funda-

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mental difference apparently would lead to the conclusion that the "same insured" requirement is violated.

The Revenue Ruling indicates that the same insured requirement is intended to prevent the indefinite deferral of gain. If such an exchange was limited to exchanges involving spouses, as discussed below, the systematic substitution of insureds whenever one insured dies would be unlikely. The policyowner, therefore, would not indefinitely defer recognition of gain on the policy value.

In two recent private letter rulings the Service considered the exchange of a last survivor policy with one surviving insured, for a life insurance policy with a single insured.[6] The Service said that the transactions would qualify as Section 1035 exchanges. Since the only insured under the new policies was the same person who was the sole remaining insured under the old policies, the Service found that the exchanges would not result in a change of insureds. In other words, the "same insured" requirement was satisfied. The Service specifically reserved ruling on whether the exchange of a single life policy for a last survivor policy would be permissible.[7]

In a case analogous to an exchange to a last survivor policy, the Service considered the meaning of the term "same" in the context of annuity payees. For an annuity exchange to qualify under Section 1035, the Regulations require that the new annuity be payable to the same person or persons as the old one.[8]

In a 1968 private letter ruling,[9] the taxpayer owned an annuity on his life, and wanted to exchange it for an annuity on his life and the life of his spouse. The Service ruled that such an exchange would violate the requirement that the annuity be payable to the same person or persons.

Although both the first and second policies were payable to the same person (i.e., the taxpayer), the Service decided that the addition of the spouse as a payee violated the "same person" requirement. If this interpretation is applied to an exchange for a last survivor policy, the exchange would fail the "same insured" test.

The rulings discussed above may be explained in part by what appears to be an underlying premise of permissible Section 1035 transactions. The premise is that it is permissible to make an exchange that does not delay the receipt of benefits by the taxpayer. This premise can be deduced from the statutory framework. Thus, the statute permits the exchange of life insurance policies for annuities but not vice-versa.[10] Endowments may be exchanged for annuities or for endowments with payments that begin no later than the payments under the original endowment. Finally, annuities may be exchanged only for annuities.[11]

Applying this hypothetical premise to the facts in the rulings discussed above results in the same holding as in each ruling. In the case involving the corporate key man policy, the substitution of a younger life for an older insured could delay the receipt of benefits. Hence, the transaction would fail the test.

It was in the key man case that the Service indirectly touched on this idea by reasoning that the "same insured" requirement prevented the indefinite recognition of gain that may result from changing insureds. Under this hypothetical premise, the exchange of the last survivor policy with only one living insured for a single life policy would be permitted because the insured life would be the same, and the receipt of proceeds would not be delayed.

Finally, the payment of the annuity proceeds to two lives instead of one probably would cause those proceeds to be received over a longer period of time than if paid based upon just one life. So, under the hypothetical premise, the exchange would not be allowed.

The exchange of a single life policy for a last survivor policy would probably delay the receipt of benefits by the taxpayer. The proceeds would not be paid until after the death of two lives, rather than the death of one life. Such an exchange violates the hypothetical premise of Section 1035, as discussed above. Of course, this premise is just conjecture — it has never been articulated by the Service. The hypothetical premise is not law; it is just a tool by which one may gain insight into Section 1035.

Rules of statutory construction direct that when a Code provision allows an exclusion from income, the provision should be interpreted strictly. In other words, one must follow the provision closely in order to take advantage of the exclusion from income. Thus, the "same insured" requirement of the Regulations[12] could be construed to deny Section 1035 treatment to an exchange to a last survivor policy. The new policy could be treated as not relating to the same insured because the insured under the new policy includes an additional life not present under the old policy.

If just the rulings to date are considered, along with the statutory framework, it appears that a single life policy cannot be exchanged for a last survivor policy under Section 1035. The reasoning applied by the Service in its rulings points to this conclusion. There are, however, strong arguments against this result. If adopted by the Service, these arguments would comport with the underlying purpose of the statute,[13] and corrective legislation would not be required. Nor would there be a need to reverse existing rulings.[14]

The "same insured" Regulation requires only that the new policy and the old policy relate to the same insured. Certainly in the question at

hand, the old policy and the new policy do relate to the same insured in the sense that one spouse is covered under both policies. The Regulation could therefore be construed on its face to permit the transaction.

The development of last survivor policies has caused a dramatic shift in estate planning. Whereas previously a single life policy on the family breadwinner was the usual approach for estate planning, the last survivor policy now provides a relatively inexpensive alternative. Today a two-wage-earner household may be less in need of survivor income than estate tax liquidity protection for the next generation. Of course, the unlimited marital deduction also has fueled the shift to last survivor policies. As a result, clients may want to exchange an existing single life policy for a last survivor policy.

In view of the changes in the marketplace, the purpose of Code Section 1035 would fit an exchange of a single life policy for a last survivor policy. That is, the last survivor policy would be better suited to the needs of many individuals. Such an exchange would facilitate estate planning for many people, a goal that is clearly within the purpose of the statute. In view of the intent of Section 1035, there is no reason to apply the "same insured" requirement to prohibit an exchange to a last survivor contract for a married couple. Instead, the Service should rule that the same insured requirement is met for a married couple, provided that one insured is the same under both contracts.

Such a result would not cost the Service any tax revenue. Receipt of death proceeds is not taxable, so the hypothetical underlying premise of prohibiting the deceleration of the receipt of benefits should not matter in this instance. Furthermore, by requiring the participants to be married, the exchange to a last survivor policy is unlikely to be abused.

The Internal Revenue Code already recognizes the importance of marriage, and the effect that taxes can have upon the stability of a family. The unlimited marital deduction is probably the best example of how marriage receives favorable tax treatment. Yet, no one has argued that the unlimited marital deduction should be eliminated because an estate can indefinitely avoid taxation if, upon the death of the first spouse, the survivor remarries.

The realities of life and living forestall such a result. The same realities should be applied to an exchange to a last survivor policy. Spouses should be allowed to engage in such a transaction under the protection of Section 1035.

If the client is informed about the current state of the law and IRS rulings, a Section 1035 exchange to a last survivor policy may be undertaken. The recommendation for a particular client should turn on the level of risk that the client is willing to take, and whether the client can afford to suffer the consequences of an unfavorable result.

If the client is audited and the Service disallows the Section 1035 exchange to the last survivor policy, the client will suffer an understatement of tax penalty, plus interest on the tax due. The penalties can add an additional 25 percent to the tax bill, before interest. The interest rate applied by the Service to overdue taxes is a rate that is usually higher than the rate the client could get at the bank for a loan. In short, it is more expensive to borrow from the Service than from the bank.

Another consideration is that if a Revenue Agent challenges a Section 1035 exchange, the Agent may look more deeply into the rest of the client's tax return. It is not unusual for the Service to find one tax problem, and on audit to discover other, more problematic areas that the client would not want examined.

If the insurers treat the exchange for a last survivor policy as a Section 1035 exchange, they may not notify the Service that a taxable event may have occurred. There is not a uniform approach to Section 1035 transactions within the insurance industry, so the client should learn how the insurers will treat the transaction before proceeding. The client should also determine whether and how any 1099 forms will be completed by the insurers. If the Service is not notified of a possible taxable transaction, the statute of limitations may not start running for the transaction.

If the client wants to exchange a single life policy for a last survivor policy, it would be prudent for the client's adviser to outline the pros and cons in a letter to the client, and to place a copy of that letter in a permanent file.

Alternatives to Section 1035 Exchange for a Last Survivor Policy

There are alternatives to a Section 1035 exchange for a last survivor policy, but they may not be as satisfying tax-wise. The client could exchange the single life policy for an annuity. The annuity could be structured to pay the premiums on the new life policy. The exchange for the annuity would not be taxed under Section 1035. When the payments are made from the annuity, however, the payments would be taxable at least partially. With this approach, the tax on the annuity payments is deferred until the payments are received. Both the annuity and the insurance policy must be bona fide contracts with risk-shifting elements.[15]

A Similar Transaction: Two Policies Exchanged for One

A question related to the foregoing is whether a husband with a single life policy, and a wife with a single life policy, may exchange their policies for a last survivor policy. At first blush this transaction might be per-

The client can exchange a single life policy for a single life policy, but the client may not exchange an annuity policy for a life policy.

missible because the new policy would relate to the same insureds as the old ones. Applying the IRS reasoning discussed above, however, leads to a contrary conclusion.

The reason, of course, is that the new contract would have a different insured than either of the old contracts. Also, the Service may reason that the fundamental substance of the contracts has changed.[16] Although the insureds would be the same, the insured under each contract would not be the same. From an actuarial standpoint the risks and values would be different. Instead of paying off at the death of the first and second life, the policy would pay off only at the last death. The receipt of benefits would be delayed, contrary to the hypothetical premise allowing exchanges if the receipt of benefits would not be delayed.

The same policy arguments discussed above also apply in this context.[17] Based upon those policy arguments, the result should be that if the owners of the last survivor policy are married, the transaction should be permitted under Section 1035. Allowing such an exchange would be in accord with the purpose of Section 1035 to prevent taxation of individuals "who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain."[18]

The Reverse Transaction: Splitting a Last Survivor Policy into Individual Policies

The reverse transaction to exchanging a single life policy for a last survivor policy is the surrender of a last survivor policy in exchange for two single life policies, one on each spouse. Since the same people are the insureds in each situation, this transaction appears to meet the same insured requirement. Also, here the exchange would result in benefits being paid earlier, not later.

Again, however, applying the IRS reasoning discussed above indicates a contrary conclusion because the insured under each contract would be, indeed, different. Also, the essence of the new contracts and the old one are different. From a practical standpoint, as long as the taxpayer does not try to manipulate the cash values for an advantage,[19] the Service may be less likely to object to this exchange because the benefits would be received sooner. Most last survivor policies provide for the split of the policy under certain circumstances, such as divorce or the elimination of the unlimited marital deduction. If the policyowners are married, and their personal situation causes them to want to split the policy, the purpose of the statute would be served by allowing them to do so.

Policy Riders

Policy riders require special consideration. If the client has a single life policy on his or her life with an annuity rider, the rider must be considered when undergoing a Section 1035 exchange to another single life policy on the client's life. The client can exchange a single life policy for a single life policy, but the client may not exchange an annuity policy for a life policy.

As a result, the annuity proceeds cannot be included in the transaction. The client may accomplish the same result by other means. For example, the client can surrender the annuity rider, make an additional premium deposit to the life policy, and then do the exchange. This transaction should not be subject to challenge under the step-transaction doctrine[20] because the client would pay any income tax due on the surrender of the annuity rider.

An alternative might be to exchange the annuity rider for an annuity policy with the new company, and then exchange the life policy for a new life policy. The proceeds from the new annuity policy could then be used to pay the premium on the new life policy. Although the annuity proceeds would be subject to taxation when withdrawn from the new annuity, at least the taxes would be deferred.

Since the Service may apply a literal translation of Section 1035, it would be best if the annuity rider could be severed from the life policy so that it would be exchanged as a separate policy for the new annuity policy. If the new company offers a life policy with an annuity rider, the client should be able to make the exchange directly, rider to rider, life policy to life policy.

Accumulation riders also must be considered separately from the base policy. If the rider is like a dividend option that accumulates dividends and then pays interest on the dividends accumulated, the accumulation would not be eligible for a Section 1035 exchange.

The reason is that the accumulation option or rider, although part of the insurance policy, is not life insurance or an annuity. If a client could transfer the accumulation as part of a Section 1035 exchange, then any investment arrangement involving a life insurance policy might qualify for Section 1035 treatment.

This was not the intent of Section 1035, which was to permit the client to adjust his or her insurance and annuity plans for changing circumstances.[21] Another indication that dividends fall outside of Section 1035 is that they are treated as a return of premium. As such, they reduce the cost basis of the policy that is transferred in a Section 1035 exchange.

Term Policies

Exchanging a term policy for a whole life contract or an annuity is a transaction that presents interesting possibilities. The statute permits this

exchange, since a term insurance policy is a life insurance policy. The advantage is that the term policy may have a high cost basis and little or no policy value.

After the exchange, the carry-over basis from the old policy should enable the policyowner to receive proceeds from the new policy as a return of basis, which is tax-free. This exchange is often overlooked even though it appears to offer some excellent planning opportunities. The client should be careful not to let the term policy lapse during the time that it takes to process the Section 1035 exchange.

Miscellaneous

Policy Loans

Policy loans pose problems under Section 1035. Clients would like to exchange policies with loans without recognizing any gain under Section 1035. But, Section 1035 treats loans as boot received in connection with the tax-deferred exchange of policies. As such, if the new policy is not issued with a loan, the amount of the loan is treated as received by the client. The amount of the loan is income to the client to the extent that the client has gain in the old policy.[22]

Most insurers will not issue a new policy with a loan on it in order to protect the client from income tax liability under Section 1035. Clients thus seek alternatives. One alternative is to borrow money from a bank to pay off the loan on the old policy. Once the loan is paid off, the client may then undertake a Section 1035 exchange. If the client desires to pay off the bank, the client may later take a policy loan on the new policy.

One should be careful, however, not to make the transaction look like a series of steps taken with a plan in mind. It is wise to allow a reasonable period to elapse between steps. Also, using different amounts of monies at each step may preclude the Service from collapsing the transaction as a step-transaction[23] and arguing that the loan is taxable.

Same Life: Two Policies for One

Another question is whether two or more policies on a life may be exchanged for one policy on the same life. Insurers are accepting these exchanges as permissible under Section 1035, although Section 1035 itself does not speak directly to this question. The statutory and regulatory language under Section 1035 speak singular in terms only. They permit the exchange of "a contract of life insurance for another contract of life insurance."[24]

However, gains and losses under Section 1035 are determined under Section 1031 of the Code,[25] and reading both Sections together indicates that a multiple policy exchange should be permissible. For example, the Regulations permit the tax-deferred exchange of one bond for several bonds under Section 1031.[26]

In a Revenue Ruling, the Service has permitted the exchange of life insurance, endowment insurance and fixed annuity policies for three variable annuities.[27] In another Revenue Ruling, rental real estate was exchanged for "farm properties" in a transaction that involved multiple properties.[28] The Service has also permitted the exchange of an old annuity for multiple annuity policies in a private letter ruling.[29]

Settlement Options

After a settlement option has been elected under an annuity, Section 1035 treatment may not be available. The Code allows deferral of gain or loss on the exchange of "an annuity contract for an annuity contract."[30] An annuity contract is "a contract with an insurance company which depends in part on the life expectancy of the insured,"[31] and which may be "payable during the life of the annuitant only in installments."[32] Once a form of life annuity is elected as a settlement option, the principal typically may not be withdrawn under the contract. If a non-life settlement option is elected, an "annuity" contract may no longer exist.

The reason would be that the payment under the contract does not depend upon the life expectancy of the insured, nor is it payable over the life of the annuitant in installments (at least not in the sense that is usually associated with lifetime annuity installment payments). On the other hand, the essence of the underlying contract itself is based upon life expectancy, and the Code does not make a distinction between annuity contracts before and after maturity.

Once a non-life settlement option is elected, the policyowner is receiving a distribution that could be eliminated or delayed after an exchange for a new contract. Such a delay appears to frustrate the apparent underlying framework of Section 1035. If the new annuity contract provides for distributions at least as fast as the old annuity contract, then Section 1035 should apply.

A problem with this approach, however, is that the insurer would have to make this determination. The insurer probably will not want to become this involved in the transaction, and the client may receive a distribution notice (i.e., a Form 1099) showing a taxable transaction.[33] The client would then have to persuade the Service that the transaction is nontaxable.

Pre-TAMRA Single Premium Policies

The treatment under Section 1035 of pre-TAMRA single premium policies does not offer a definite solution. The concern is whether the exchange of a single premium policy will cause

Most insurers treat existing cash values in a Section 1035 exchange as they would treat cash values under a policy that undergoes a material change.

the policy to become a modified endowment contract even though the old policy was grandfathered under TAMRA. Most insurers treat existing cash values in a Section 1035 exchange as they would treat cash values under a policy that undergoes a material change.

This treatment makes sense because in both cases the result is the same, that is, the policy is changed. When a policy undergoes a material change, the 7-pay limit must be recalculated. Although the Code does not address how to handle the existing cash values in such a case, the Committee Reports[34] explain the procedure to use.

Under this procedure, the existing cash values can never cause the policy to violate the 7-pay rules, although they may limit the amount of additional premium that can be paid on the policy. As a result, the FIFO rules of the single premium policy will carry over to the new policy, although the new policy is subject to the 7-pay rules. This result is especially important when one considers that the first generation of universal life policies is beginning to run its course, and that clients need the flexibility to change to newer, more competitive policies, without being penalized with a tax liability.

The major difference between the old policy and the new one is that with the old one the client knows for sure that the FIFO rules apply. On the new policy, the method used by insurers to consider existing cash values in a Section 1035 exchange is not expressly set forth in the Code or the Committee Reports. Nor has it ever been expressly articulated by the Service. There is no guarantee that the new policy will be subject to FIFO treatment.

Exchanges to Irrevocable Trusts

A client with an irrevocable trust may not avoid the three year contemplation of death rule by transferring a policy into the trust via a Section 1035 exchange. The client may have an old policy outside of the trust, and the client may desire to exchange the old policy for a new policy that would be owned by the trust. The new policy would not exist but for the action of the client in exchanging the old policy for it.

This is true even though the client may not sign the new application. If the trustee signs the application as applicant and owner, and is named as beneficiary, the three year rule should still apply.

Although a full discussion of the three year rule is beyond the scope of this article, the control factor at the foundation of the three year rule should be present if the client surrenders the old policy and that policy surrender is used in exchange for a new policy. **J**

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(1) Code Section 1035 provides as follows: "No gain or loss shall be recognized on the exchange of: (1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; or (2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract, or an annuity contract for an annuity contract... ."
(2) 11 H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 81 (1954).
(3) Treas. Reg. §1.1035-1(c).
(4) Rev. Rul. 90-109, 1990-2 C.B. 191.
(5) A Revenue Ruling is unlike a private letter ruling, which has application only to the particular case being considered. The Service does not allow private letter rulings to be cited as authority for other cases. The reason is that the process of issuing private letter rulings is less stringent than for Revenue Rulings, A Revenue Ruling is reviewed more thoroughly and more carefully by the Service before it is published.
(6) Priv. Ltr. Rul. 93-30-040 (May 6, 1993); Priv. Ltr. Rul. 92-48-013 (Aug. 28, 1992).
(7) Priv. Ltr. Rul 92-48-013 (Aug. 28, 1992).
(8) Treas. Reg. §1.1035-1(c).
(9) Priv. Ltr. Rul. 68-06-260330A (June 26, 1968).
(10) The assumption apparently is that the taxpayer will receive all benefits under an annuity policy during his or her lifetime, while the life insurance proceeds will not be received until death.
(11) IRC §1035.
(12) Since the "same insured" requirement would appear to have a logical basis in the statute, this article does not consider whether the Regulation should be subject to challenge as being overly broad. For example, without this requirement a policy could be exchanged indefinitely by substituting different lives for the insured. The death proceeds might never be paid in such a case. Such a result would probably not be an intended result of the application of Section 1035. So, at least in this respect, the "same insured" requirement would appear to make sense.
(13) The purpose is to prevent taxation of individuals "who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." 11 H.R. Rep No. 1337, 83rd Cong., 2d Sess. 81 (1954).
(14) For example, the reasoning used in Revenue Ruling 90-109 (discussed at text accompanying note 4) could be explained away by citing the statutory purpose of accommodating changing needs, and the unlikely possibility of abuse if the exchange was limited to spouses. Both of the other rulings cited are private letter rulings. As such, they have no precedential value, and can be ignored.
(15) If there is no risk-shifting there is no insurance involved, and the proceeds of the life insurance policy will not qualify as income tax free. Helvering v. LeGierse, 312 U.S. 531 (1941).
(16) *See supra* text accompanying note 4.
(17) *See supra* text following note 14 above.

(18) H. R. Rep., *supra* note 3.
(19) This transaction gives the taxpayer the opportunity to manipulate the amount of cost basis that is attributed to the new contracts in a way that would allow the taxpayer to avoid recognition of gain. The discussion assumes that no such manipulation is intended.
(20) Under this doctrine the Service may collapse a transaction that has several steps, so that it may be viewed as one overall transaction. Sometimes this is necessary because the individual steps themselves do not trigger a tax, while the overall transaction will trigger a tax.
(21) H.R. Rep., *supra* note 3.
(22) In general, gain is determined as follows: 1. Add up all premiums paid on the policy, and subtract any dividends. 2. Add up the cash surrender value, plus the amount of outstanding loans (if not included in the cash surrender value). 3. If (2) is greater than (1), subtract (1) from (2). The difference is the gain.

If (2) is less than (1), there is no gain. In such a case the policyowner may surrender the policy and apply the proceeds to a new contract without paying any tax. Upon surrender the policyowner would not be able to carry over his or her "loss" basis to the new contract. Often such a carryover is not a concern to the policyowner. If the amount of the loan exceeds the gain, the excess is not taxable at the time of the exchange.
(23) *See supra* note 20.
(24) IRC 1035(a)(1); Treas. Reg. §1.1035-1(a).
(25) Treas. Reg. §1.1031(b)-1(a)(2).
(26) Treas. Reg. §1.1031(b)-1(b), 2.
(27) Rev. Rul 68-235, 1968-1 C.B. 360.
(28) Rev. Rul. 72-151. 1972-1 C.B. 225.
(29) Priv. Ltr. Rul. 62-12-194820A (Dec. 19, 1962).
(30) IRC §1035(a)(3).
(31) IRC §1035(b)(1).
(32) IRC §1035(b)(2).
(33) Some companies do this routinely for all exchanges under Section 1035.
(34) "In the case of a contract that is materially changed due to an increase in future benefits that is attributable to a premium that is not necessary to fund the lowest death benefit payable in the first seven contract years, the amount of the premium that is not necessary to fund such death benefit is to be subject to the 7-pay test without regard to the timing of the premium payment. In applying the 7-pay test to any premiums paid under a contract that has been materially changed, the 7-pay premium for each of the first seven contract years after the change is to be reduced by the product of (1) the cash surrender value of the contract as of the date that the material change takes effect (determined without regard to any increase in the cash surrender value that is attributable to the amount of the premium payment that is not necessary), and (2) a fraction the numerator of which equals the 7-pay premium for the future benefits under the contract, and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 7-pay premium." Conference Committee Report to TAMRA Section 5012.