As Published In

JOURNAL

OF THE AMERICAN SOCIETY OF CLU & ChFC

Still More on Section 1035

by

DOUGLAS I. FRIEDMAN, JD, CLU
HEATHER C. DOWNEY, JD, LLM

May 1998/Vol. LII, No. 3

Still More on Section 1035

DOUGLAS I. FRIEDMAN, JD, CLU
HEATHER C. DOWNEY, JD, LLM

Abstract: *This article summarizes recent IRS rulings on Section 1035 exchanges and comments on their effect on the taxation of these exchanges. These rulings deal with the "immediate annuity" exception to the penalty for premature withdrawals, the exchange of multiple policies for one policy, and the exchange of one policy for multiple policies, among other issues. The authors then summarize some unanswered questions regarding the taxation of Section 1035 exchanges.*

Internal Revenue Code (IRC) Section 1035[1] provides for the nonrecognition of gain or loss on certain exchanges of insurance policies and annuities. Since 1993, the Internal Revenue Service (IRS) has issued numerous rulings regarding Section 1035 transactions, and insurance professionals have continued to "push the envelope" for such exchanges. This article provides an overview of recent rulings along with appropriate commentary.[2]

IRS Rulings Since 1993

Purchase Date of Original Annuity Carries Over to New Annuity: "Immediate Annuity" Exception Not Met. (Rev. Rul. 92-95, Oct. 26, 1992)

This Ruling determines the annuity purchase date when an annuity is exchanged for another annuity under Code Section 1035. This date is important for the "immediate annuity" exception to the penalty tax for premature withdrawals.[3] The immediate annuity exception has three parts: (1) the annuity must be purchased with a single premium or annuity consideration; (2) the annuity starting date must be within one year from the date of purchase of the annuity; and (3) the annuity must provide for a series of substantially equal periodic payments during the annuity period.[4]

In this ruling, the taxpayer purchased an annuity in 1987. In 1991, the taxpayer exchanged this annuity for another annuity in a Section 1035 exchange. Almost immediately after the exchange, the taxpayer began receiving a series of substantially equal monthly distributions from the new annuity. The taxpayer intended this arrangement to satisfy the "immediate annuity" exception.[5] The IRS found that the annuity starting date was later than one year from the date of the purchase of the annuity; therefore, the exchange did not meet the exception.

In its analysis, the IRS recognized that a replacement contract received in a tax-free exchange is a continuation of the old investment, so it retains some of the old contract's attributes. The IRS stated that the basis of the immediate annuity exception was the "relative absence of the opportunity for tax benefit attributable to deferral of income on the contract."[6] In other words, since the immediate annuity would be purchased within one year of making the investment, there would be little time for the deferral of income that could result from a longer accumulation period. But the IRS pointed out that under the facts before it, the new annuity contract contained tax-deferred income that was earned under the old annuity contract. The IRS reasoned that one attribute the new contract must retain is the date when amounts are considered to have been invested in the new contract. Otherwise, the IRS reasoned, the taxpayer would receive an unwarranted tax benefit—the ability to use the immediate annuity exception. The IRS concluded that the date of purchase of the old contract is the date of purchase to be used in determining whether there is an immediate annuity for purposes of the penalty provision.[7]

Unfortunately, there is widespread misunderstanding about the immediate annuity exception to the penalty tax. Many professionals believe that electing an annuity option within one year of making a Section 1035 exchange is sufficient to meet the one year requirement. This is understandable in view of another exception to the penalty tax, which provides that

This issue of the Journal went to press in April 1998.

Since an annuity may also be paid over a person's lifetime, the practical effect of the life expectancy exception may be the same as the immediate annuity exception.

---

there is no penalty when substantially equal periodic payments are made for the life or life expectancy of the taxpayer or the joint life expectancies of the taxpayer and his or her designated beneficiary.[8] The difference between this exception and the immediate annuity exception is the length of time over which payments may be made. An annuity permits payments over a term of years, without reference to the taxpayer's life.[9] Since an annuity may also be paid over a person's lifetime, the practical effect of the life expectancy exception may be the same as the immediate annuity exception.

For example, if substantially equal payments are taken over one's lifetime, the result is similar to payments that would be made under an immediate life annuity. Thus, if a client desires to avoid the penalty tax, substantially equal periodic payments for life or life expectancy can be elected even though the immediate annuity option may not be available. In view of the foregoing, and the fact that annuities are used as accumulation vehicles, one would think that it should not matter when the annuity option is elected. The important thing should be that the immediate annuity is taken. Presumably whatever public purpose is served by the "substantially equal" exception would also be met by the immediate annuity election.

Original purchase date does not carry over for step-up in basis. (Priv. Ltr. Rul. 93-46-002, July 26, 1993)[10]

In this letter ruling, the taxpayer's mother purchased a variable annuity in 1974. In 1989, she exchanged the variable annuity for a new annuity under Section 1035. At the time the original annuity was purchased, a taxpayer's estate would have received a step-up in basis at the taxpayer's death for a variable annuity owned by the taxpayer. By 1989, however, the law had changed so that there was no longer a step-up in basis. Annuities purchased before the change in the law would continue to receive a step-up under a "grandfather" provision.[11]

The taxpayer's mother died in 1990, before the annuity starting date, and left the annuity to the taxpayer. The taxpayer argued that he should receive a step-up in basis for the new annuity because he would have been entitled to the stepped-up basis under the law at the time the original annuity was purchased.

The IRS disagreed, arguing that although the basis and holding period of the old contract would carry over, the exchange in 1989 would be considered a new purchase. Since there was a "purchase" of a new contract after the law had been changed, the new contract would not be entitled to the beneficial treatment afforded by the old contract. The IRS explained that the purpose of the grandfather provision was to ensure that taxpayers who had purchased a policy before the change in the law would not be harmed by the change. The IRS said that the taxpayer's mother had voluntarily changed her position by giving up the old policy in exchange for the new policy.

The reasoning of this private letter ruling conflicts with Revenue Ruling 92-95, discussed previously. There the IRS found that the date of purchase of an old annuity contract is an attribute that is retained by a new annuity contract under a Section 1035 exchange. Here, the IRS argues that there is a new purchase upon the exchange. The IRS's analysis, focusing on the date of purchase, could have been clearer. One would think that "date of purchase" means "date of purchase" despite the context. The reasoning could simply have been that the law had changed; therefore, the grandfather provision did not apply. Perhaps the apparent conflict in reasoning in these two rulings can be explained because a private letter ruling does not receive the same degree of Treasury Department scrutiny as revenue rulings.[12] In any case, annuities apparently do not receive a step-up in basis in these circumstances.

Exchanges involving two lives. (Priv. Ltr. Rul. 95-42-037, July 21, 1995)

This letter ruling addresses several common situations regarding Section 1035 exchanges. In situation one, a husband exchanges a life insurance contract insuring his life for a last survivor policy covering the lives of both spouses. In situation two, a husband exchanges two life insurance contracts, one covering his life and one covering his spouse's life, for a last survivor contract covering the lives of both spouses. In situation three, both spouses exchange separate single-life policies insuring each of their lives for one last survivor policy covering the lives of both spouses. In situation four, the facts are the same as in situations one and two, but a trust is the owner of the policies involved.

In a brief ruling, the IRS first noted that for Section 1035 to apply, the regulations require that policies exchanged "relate to the same insured."[13] The IRS then discussed a prior revenue ruling that involved a corporate-owned key person life insurance contract.[14] In the prior ruling, to provide flexibility to the corporation's key man insurance program, the policy permitted the corporation to substitute a different person for the person insured. When the corporation substituted a new insured for the existing insured, the IRS said that because the "same insured" requirement was not met, Section 1035 did not apply.

In reaching its conclusion on each of the four situations described above, the IRS reasoned that the individual insured under each contract given up in the exchange was not the "same insured" under the contract received in the exchange. Since the

contracts did not relate to the same insured, they would not qualify for nonrecognition treatment.

Private Letter Ruling 95-42-037 does not comport with the purpose of Section 1035, which is to allow an individual to change the nature of his or her insurance program according to changes in his or her personal situation.[15] The IRS can justify its decision in situation one with the argument that only one life was insured under the first contract and there are two lives insured under the second contract. But a taxpayer might just as well argue that since one particular life is insured under both contracts, the "same insured" requirement is met.[16]

The conclusions in situations two and three come much closer to falling within the rationale of permitting the flexibility that underlies Section 1035. In both situations, a change in family or insurance needs is probably the motivating factor. In situation two, as the client and spouse grow older, the need for single-life coverage may decrease as the size of the estate increases. In such a case, last survivor coverage becomes important for estate tax purposes. Likewise, in situation three, there could be a second marriage situation where estate taxes have become important. In that case, each spouse is likely to own a contract on his or her life that could be used for a last survivor policy. The IRS has sometimes analyzed whether the "same insured" requirement has been met by examining the actuarial basis of the contracts involved.[17] Although in both situations the actuarial nature of a single-life policy is different from a last survivor policy, if the transactions are viewed as a whole, two insureds exist under the old contracts and the same two insureds exist under the new contract.

This ruling should be read in conjunction with Private Letter Ruling 92-48-013 in which the IRS permitted the trust owning the policy to exchange a last survivor policy for a single-life policy on the survivor after the death of one insured.[18] The IRS based its decision on the fact that the only remaining insured under the last survivor policy was the "same insured" as under the single-life policy. Note that the actuarial basis of these two contracts is, of course, markedly different, but the IRS did not take that fact into consideration.

Thus, as to situations such as those previously discussed, the "same insured" requirement defeats the intended purpose of the statute, and should therefore be discarded.[19]

Exchanging one contract for two contracts, and vice-versa (Priv. Ltr. Rul. 96-44-016, July 18, 1996; Priv. Ltr. Rul. 97-08-016, February 21, 1997)

In the 1996 ruling, the IRS approved the exchange of one annuity for two annuities under Section 1035.[20] The IRS recognized that the tax code already permits nonrecognition treatment, under Section 1031, for exchanges of multiple like-kind properties such as real estate. Since Section 1035 is built upon premises similar to Section 1031, Section 1035 was also found to permit such exchanges.[21] In addition, the IRS noted that the Revenue Code provides that words in the singular are meant to include the plural unless a code section shows otherwise.[22] Although it was not the subject of this ruling, the IRS's discussion of these issues shows that it should also permit the exchange of multiple annuity contracts for a single annuity contract under Section 1035.

Continuing this line of reasoning, in the 1997 ruling, the IRS approved the exchange of two nonparticipating flexible premium life insurance policies with adjustable death benefits for one nonparticipating flexible premium variable deferred annuity contract. Similar to the 1996 annuity ruling, the IRS reasoned that the tax code allows exchange of multiple properties for one property.

The combination of these rulings may produce unintended results. It would now seem clear, for example, that an individual can exchange one life insurance contract for two life insurance contracts. Unlike annuities, life insurance contracts are not grouped together for tax purposes.[23] A taxpayer cannot avoid adverse income taxes by dividing the cash values of an annuity contract between two new contracts, one with a high basis and one with a low basis, and then withdrawing his or her money from only the high basis contract. The same treatment is not true of life insurance contracts.

If one life insurance contract is exchanged for two new contracts, the cash values would have to be allocated between the two new contracts, which could lead to interesting results. For example, in view of the now infamous Technical Advice Memorandum on split dollar,[24] clients have become much more concerned with how they will end a split-dollar arrangement. Under the private letter rulings discussed here, the taxpayer in a collateral assignment split dollar may exchange one life insurance contract for two contracts. The taxpayer may request that the insurer[25] issue one contract with a cash value equal to the premiums paid by the employer, and the other with a low cash value and a high face amount. The contract with the high cash value could be transferred back to the employer in satisfaction of the employer's interest under the split-dollar arrangement. The low cash value contract would then be retained by the taxpayer.

There does not appear to be any adverse tax consequences to the taxpayer for such a transaction. If the insurer treats such an exchange as a policy division, presumably there would be no force out of cash values, if the policies are designed appropriately.[26] The taxpayer could, in any

Since the converted policy arises from the exercise of a provision in the term policy, the old permanent contract is technically not being exchanged for the converted policy.

event, always borrow cash from the existing contract to pay off the employer without any adverse tax consequences. But the advantage to the taxpayer in the exchange scenario is that the taxpayer is left with a viable contract that he or she can continue by paying premiums. When cash is borrowed from a contract, the death benefit is reduced by the amount of the loan. Sometimes, the contract will not be viable without a large cash infusion. The same may be true if cash is withdrawn from the contract instead of taking a loan. Also, the remaining face amount may not be sufficient for the client's needs.

Still Unanswered Questions

Section 1035 still leaves many unanswered questions, as discussed below.

Exchanging a single-life policy for a joint and survivor annuity.

This situation may arise when a last survivor policy with a guaranteed premium has been purchased. The client may want to guarantee the payment of the last survivor premium by purchasing an annuity. Since the life insurance premium may continue until the second death, the annuity must be a joint and survivor annuity. Sometimes the funds for the annuity come from an old single-life policy.

Such an exchange probably does not meet the requirements of Section 1035, although the rules do not specifically address such an exchange. For life insurance contracts, the insured must be the same under both the new and the old contract.[27] For annuities, the obligees must be the same.[28] Here, the IRS's strict interpretation of the "same insured" requirement probably would preclude Section 1035 treatment. As with the 1995 private letter ruling discussed previously, the addition of a second life to the transaction would probably cause the IRS to disqualify it.

Exchanging a last survivor contract (with both insureds alive) for an annuity.

This situation has not yet been addressed by the IRS. Based on the aforementioned, however, one would expect that such an exchange would be permissible under certain circumstances. Keep in mind the rules for insurance contracts and annuities about the insureds and the obligees. If the obligees under the annuity are the same as the owners and the insureds of the last survivor contract, then the regulations seem to be met. This would mean that the annuity should be a joint annuity.

Any other combination would not be as clear. If the insureds and obligees are the same, but the owners are different, the implicit requirement of an exchange — that the same taxpayer begin and end the transaction[29] — would not be met. Any other combination of insureds and obligees would probably run afoul of the requirements for the same insured or same obligee.

Exchanging a first-to-die contract with both insureds alive for a last survivor contract for the same insureds.

Here the insureds are the same under both contracts, but the actuarial basis is very different. How the IRS would treat this situation is difficult to determine. Because the insureds are the same, the "same insured" requirement is met. But if the IRS applies a restrictive reading of Section 1035, it could deny favorable treatment because the actuarial basis of the two contracts is significantly different.[30]

Conversion of a term policy to a permanent policy.

In situations like this, one should look at the contract rights that are involved. In this instance, the right of conversion is clearly attached to the old policy. Thus, the new policy is the result of exercising a right under an old policy. The insurance company has no choice but to issue the converted policy. The new policy is not issued in exchange for the old policy but is issued because of the exercise of a policy right residing in the old contract.

This question usually arises because the client has an old permanent contract that he or she wants to roll into the converted policy under Section 1035. Since the converted policy arises from the exercise of a provision in the term policy, the old permanent contract is technically not being exchanged for the converted policy. So, the transfer of the cash values from the old policy should not qualify as a Section 1035 exchange.

Note that this question is different from whether a term policy may be exchanged for a whole life policy under Section 1035 — a question beyond the scope of this article. Suffice it to say that an argument may be made on either side of that issue.

Exercising guaranteed insurability riders.

Sometimes the client wants to roll an old permanent policy into a new policy created by the exercise of a guaranteed insurability rider. Again, one should look to the rights involved in the issuance of the new policy. The analysis should be the same as for the exercise of a conversion right, as discussed. The transaction is not likely to meet the requirements of Section 1035.

Exercising a right of exchange.

As insureds live longer, the possibility increases that they will live to age 95 or 100. Then, under a traditional whole life contract, the policy matures for the face amount and the proceeds will be paid. Under a universal life contract, age 95 or 100 usually is the ultimate age, which is the age at which the cost of one dollar of insurance is equal to one dol-

lar. To continue a universal life policy past the ultimate age may cause all the cash values to be charged to the current cost of insurance. Neither of these results is desirable.

One solution[31] may be to allow the policyholder to exchange the existing contract for a life paid-up at 95 contract (or 100, as the case may be). In that instance, the exercise of the policy right should not cause any taxation to the policyholder. The policyholder is not really receiving a new policy in exchange for an old policy. Only the form of the contract is changing, as in the exercise of other policy rights discussed previously. The new policy is simply an extension of the old one.

Exchanges involving an irrevocable trust.

Sometimes a client wants not only to change the form of his or her insurance, but also to do some estate planning. The client may do a Section 1035 exchange and then establish an irrevocable trust to hold the life insurance. In such a case, the new policy should not escape the three-year contemplation of death rule.[32] Again, applying the analysis about the contract rights involved, the policyholder is transferring cash values under a policy that exists outside the irrevocable trust. Transferring those values, and the rest of the policy attributes that carry over, into the trust should cause the new policy to be subject to the three-year rule. This result will ensue even if the trustee is the owner, applicant, and beneficiary of the new policy.[33]

If the client wants to contribute the new policy to an irrevocable trust, there may be a difference in estate taxes depending upon the timing of the exchange. Exchanging the policy first, and then contributing it to the trust will result in the three-year contemplation of death rule applying to the entire face amount. If the client contemplates increasing the face amount on the new policy, as is often the case, the client should consider placing the policy in the trust before the Section 1035 exchange. Then, arguably, if the trustee conducts the exchange and increases the face amount, the increase may be excluded from the three-year rule.[34] Although the IRS may apply the step-transaction doctrine in arguing that the treatment would be the same one way or the other, it is not clear that the IRS would prevail.[35] Since it is usually just as easy to do the transaction one way as the other, the second method should be preferable. To help avoid the imposition of the step-transaction doctrine, the taxpayer should stagger the transactions with a significant period of time in between so that they do not appear to be one integrated scheme.

Reducing policy loans to less than cost basis.

If there is a policy loan and the new policy is issued without a loan, the amount of the loan is treated as "boot."[36] In general, boot is taxable to the extent that the taxpayer has a gain on the contract at the time of the exchange. The Code is explicit in this treatment, and Section 1031, which governs Section 1035, gives examples in which property subject to a loan is exchanged.[37]

Section 1035 predates the arrival of universal life policies. Under a universal life policy one may withdraw cash value without making a loan. The taxpayer may withdraw up to his or her total investment in the contract without recognizing income. So, if the taxpayer withdraws cash, and then does a Section 1035 exchange, the taxpayer may escape the recognition of income that might result if there was a loan outstanding on the contract during the exchange.

It has been suggested that because of the ability to withdraw cash as a return of basis, the taxpayer need only pay the loan down so that it is less than the taxpayer's basis in the policy during a Section 1035 exchange. The argument is that since the basis would equal or exceed the loan, and the taxpayer could withdraw an amount equal to basis without recognizing income, there should be no taxable income from the exchange. This situation combines the best of two worlds, but the tax code, and Section 1035 in particular, do not support such an analysis.

Section 1035 is an exclusionary provision; that is, if a transaction qualifies for treatment under Section 1035, the taxpayer can exclude what otherwise would be a gain from income. Such a provision is construed narrowly by courts.[38] The judicial assumption is that if Congress intended to expand the statutory provisions to cover other transactions, then Congress would have expressed that desire in drafting the statute.

Here, as previously noted, the tax code expressly discusses exchanges that involve loans. While no ruling discusses this issue in the context of life insurance policies, a similar issue has been addressed regarding annuities. In one private letter ruling,[39] the taxpayer purchased an annuity. Four years later, the taxpayer withdrew an amount equal to the basis and purchased a life insurance policy. The next day the taxpayer exchanged the values remaining in the annuity for a new annuity. The IRS denied favorable treatment under Section 1035 by combining the steps and viewing them as one transaction. Since an annuity cannot be exchanged under Section 1035 for a life insurance policy, the value of the life insurance policy was treated as taxable "boot."[40]

In another ruling,[41] the IRS reached a similar result. The taxpayer purchased an endowment policy in 1986 and later took a policy loan. A few years later, the annual rate of interest went down and the taxpayer wanted to change his investment. Presumably realizing the effect of Section 1035 exchanges on policy loans, the tax-

Section 1035 continues as a fertile area for imaginative thinking.

payer proposed paying off the loan through a partial surrender of the policy. After the loan was paid off, the taxpayer would exchange the policy for a new endowment policy with a new company. The IRS found that the exchange qualified under Section 1035, but there would be gain recognized on the value of the loan that was extinguished. The IRS reasoned that the taxpayer did not actually intend to partially surrender the old policy for cash as an isolated transaction. Instead, the IRS said that the taxpayer intended not only to exchange the old contract for a new one, but also simultaneously to receive the value of the extinguished loan. The IRS collapsed the two steps into one and treated the partial surrender as the receipt of taxable boot, as if it were a loan extinguished in a Section 1035 transaction.

In both rulings, the withdrawal of cash and extinguishment of the loan occurred near the time of the Section 1035 transaction. Thus, one key element is the timing of the transaction. The further apart that the transactions occur, the more likely that the separate transactions will not be collapsed and treated as one transaction. No one has ascertained how much time is sufficient. But the IRS has certainly shown in these annuity rulings what it thinks about the nature of these transactions. If the express language of the tax code is not enough, the IRS's actions with respect to annuities is certainly cause for concern.

Conclusion

Section 1035 continues as a fertile area for imaginative thinking. Unfortunately, the IRS has taken a restrictive view of this Code provision. Generally, the IRS has ruled against taxpayers who try to follow the congressional intent of the provision: to provide flexibility in insurance plans to accommodate the taxpayer's changing needs. Hopefully the future will hold a more lenient approach. But with the ever-present need for government revenue, a favorable future may be far off. **J**

(I/R Code No. 2500.00/2750.07)

Douglas I. Friedman, JD, CLU, is the senior partner in the Birmingham, Ala. law firm of Friedman & Pennington, P.C. where he counsels life insurance companies and businesses about market conduct issues, advanced sales matters, and the development and marketing of special products for the advanced sales market. He is a member of the Bars of Alabama and New York and received his undergraduate degree from the University of Virginia and his JD from Vanderbilt University.

Heather C. Downey, JD, LLM, is an associate with Friedman & Pennington, P.C., Birmingham, Ala. She received her bachelor's degree from Vanderbilt University, her law degree from Cumberland School of Law, and her LLM in taxation from the University of Denver. Ms. Downey is a member of the Bars of Alabama and Colorado and a member of the American Bar Association and its section on Taxation.

(1) I.R.C. § 1035 states:
"(a) GENERAL RULES
No gain or loss shall be recognized on the exchange of—

(1) a contract of life insurance for another contract of life insurance or endowment or annuity contract; or

(2) a contract of endowment insurance for (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

(3) an annuity contract for an annuity contract."

All references to code sections are references to the Internal Revenue Code of 1986 as amended, unless stated otherwise.

(2) *See also* Douglas I. Friedman, *Section 1035 Exchanges and Modified Endowment Contracts*, J. Am. Soc'y CLU & ChFC, July 1989, at 62; Douglas I. Friedman, *Section 1035: The Gray Areas of Policy Exchanges*, J. Am. Soc'y CLU & ChFC, Nov. 1993, at 66 [hereinafter *Gray Areas*].

(3) This exception can be found at I.R.C. § 72(q)(2)(I).

(4) *See*, I.R.C. §§ 72(q)(2)(I); 72(u)(4).

(5) *See*, § 72(q)(2)(I).

(6) Rev. Rul. 92-95, 1992-2 C.B. 43.

(7) Under this analysis, presumably contributions made within one year of the conversion to an annuity would meet the one-year requirement. To say the least, such an approach would raise computational difficulties.

(8) I.R.C. § 72(q)(2)(D).

(9) For example, it could be an annuity for a term of five years, ten years, etc.

(10) Private letter rulings have no precedential value. I.R.C. § 6110(j)(3). They are binding only on the parties involved; nevertheless, they do indicate how the IRS stands on particular issues.

(11) I.R.C. § 7805(b).

(12) Different levels of scrutiny are applied to the various types of rulings issued by the IRS. Revenue rulings, which may be cited as precedent, are reviewed at several different levels, including the Chief Counsel. In contrast, private letter rulings, which may not be cited as precedent, are reviewed usually only by the Branch Chief.

(13) Priv. Ltr .Rul. 95-42-037 (July 21, 1995), citing Treas. Reg. § 1.1035-1.

(14) Rev. Rul. 90-109, 1990-2 C.B. 191.

(15) *See*, Priv. Ltr. Rul. 94-30-043 (May 6, 1994) (citing H.R. Rep. no. 1337, 83rd Cong. 2d sess. 81 (1954); Priv. Ltr. Rul. 96-44-016 (July 18, 1996).

(16) This argument is particularly appealing when one considers that the "same insured" requirement does not appear anywhere in the tax code or in committee reports. Instead, it was grafted onto the law by the IRS in what arguably is an unwarranted and unnecessary extension of the tax code. To buttress its arguments along these lines, the IRS sometimes discusses the actuarial nature of the contracts involved. If that nature is substantially different, the IRS may use that difference to support its reasoning. Certainly there is still a substantial actuarial difference between a single-life contract and a last-survivor contract.

(17) See explanation *supra* note 16.

(18) Priv. Ltr. Rul. 92-48-013 (Aug. 28, 1992) was discussed in *Gray Areas*, *supra* note 2.

(19) For further discussion of this topic see *Gray Areas*, *supra* note 2.

(20) Although the exchange qualified under § 1035, the IRS pointed out that the taxpayer will not be able to avoid the "income-out-first" rule and that the new contracts would be treated as a single contract for that purpose. *See* I.R.C. § 72(e)(11).

(21) The IRS's reference to § 1031 as a guide to the interpretation of § 1035 results from a direction in the tax code to analyze § 1035 exchanges like exchanges under § 1031. *See* § 1035(c).

(22) I.R.C. § 7701(m)(1).

(23) Annuities are treated as one contract if issued by the same insurer within the same year. I.R.C. § 72(e)(11).

Still More on Section 1035

(24) Tech. Adv .Mem. 96-04-001 (Sept. 8, 1995).
(25) Some insurers may insist on a cash value proportionate to the face amount on each new policy, but this area is new enough that the industry is still responding to these issues.
(26) A force-out could occur if the cash value was too low in relation to the cash value. In other words, a force-out could occur if it was necessary to maintain the policy's qualification as life insurance under the tax code.
(27) See text and notes 13-17, *supra*, discussing Priv. Ltr. Rul. 95-42-037.
(28) Treas. Reg. § 1.1035-1.
(29) *Black's Law Dictionary* 6th ed. defines exchange as "To barter; to swap. To part with, give or transfer for an equivalent. To transfer goods or services for something of equal value...." This definition implies that the same person begins and ends the transaction.
(30) Under the last survivor contract, payment is made at the second death, and not at the first death, as under the first-to-die contract.
(31) There are many possible solutions to this problem, such as raising the maturity age to 120.
(32) *See* I.R.C. § 2035.
(33) Generally, such designations avoid the three-year rule for a new policy purchased by the trustee.
(34) Note that although the trustee may engage in a § 1035 exchange, unlike the transfer of existing policy rights into the trust, there is no right to force an insurer to accept a § 1035 exchange. Instead, the trustee is just changing the form of the assets in the trust to maximize the benefits under the trust.
(35) The step-transaction doctrine is the theory that views transactions occurring near each other in time as one transaction. All the transactions are collapsed and viewed as one transaction, and the substance of the transaction is analyzed instead of the form. *See* Priv. Ltr. Rul. 91-41-025 (July 11, 1991); Kanawha Gas and Utilities Co. V. Commissioner, 214 F.2d 685 (5th Cir. 1954).
(36) Treas.Reg. § 1.1031 (b)-1(a).
(37) Treas.Reg. § 1.1031(j)-1(a).
(38) *See*, Commissioner v. Schleier, 515 U.S. 323, 115 S.Ct. 2159 (1995); United States v. Centennial Savings Bank FSB, 499 U.S. 573, 111 S.Ct. 1512 (1991); Commissioner v. Jacobson, 336 U.S. 28, 69 S.Ct. 358 (1949).
(39) Priv. Ltr. Rul. 38-05-004 (Oct. 17, 1988).
(40) Treas. Reg. § 1.1035-1.
(41) Priv. Ltr. Rul. 91-41-025 (July 11, 1991).