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AALU Bulletin No: 08-07

January 22, 2008

Subject: **Exchange of Corporate-Owned Life Insurance Policies For Individual Policies Will Be Tax-Free Under IRC §1035**

Major References: [PLR 200801001](#)

Prior AALU Washington Reports: 07-43; 07-17; 06-132; 06-127; 06-121

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*In PLR 200801001, the Revenue Service ruled that a corporation's proposed exchanges of certain certificates issued under a group policy and certain individual COLI policies for individual, separate account COLI policies with respect to currently active employees will be tax-free under Section 1035 of the Internal Revenue Code. Further, the basis and the investment in the contract of the newly issued contracts will be the same as that of the contracts for which they were exchanged.*

Under the facts as presented in the PLR, "Taxpayer" is the parent company of Subsidiary, which maintains what the private letter ruling describes as a "Business-Owned Life Insurance (BOLI) program." The program is not stated to be a "bank" program (which is typically described as "BOLI") and it appears that the "Business-Owned Life Insurance" program is more accurately what is called in the industry a Corporate-Owned Life Insurance (COLI) program. We will, therefore, here refer to the program addressed in the PLR as "COLI."

As part of its COLI program, Taxpayer owns a group policy with individual COLI policies issued by Company 1, and individual COLI policies issued by Company 2. There are no master contracts as defined by section 264(f)(4)(E) and all of the policies are general account policies that insure the lives of Taxpayer's active employees. In the group contract policies issued by Company 1, the individually covered

employees are identified by separate policy certificates. The private letter ruling, in an early part of its text, identifies the group contract policies as "single premium modified endowment contracts" and the individual COLI policies as "flexible universal life insurance contracts." (At a later point in the text, the PLR states, with a certain inconsistency, that Taxpayer identifies all the "contracts to be exchanged \*\*\*[as]\*\*\* modified endowment contracts.") No policy loans exist currently, or in the past, with respect to any of the COLI policies currently held by Taxpayer.

Taxpayer proposes to exchange the individual certificates issued by Company 1 under the group COLI policy on its general account for individual, separate account COLI policies under a variable adjustable life insurance group policy also issued by Company 1. Taxpayer also proposes to exchange the individual general account COLI policies issued by Company 2 for individual separate account COLI policies issued by Company 3. Each of the new separate account COLI policies will be issued to the same policyholder and on the same lives as the certificates surrendered in the exchange. There will be no change in the face value of the policies except to the extent necessary to continue to comply with the cash value accumulation test or the guideline premium requirements under section 7702(a). Taxpayer does not now intend to surrender or make distributions from either the existing policies or the new policies. Prior to the proposed exchange, Taxpayer will obtain written consent from each active employee for which an exchange is proposed.

As described above, all COLI contracts to be exchanged are MECs. Neither Taxpayer nor the insureds will receive any of the cash surrender value of the current general account COLI contracts exchanged.

On these facts, the Revenue Service ruled as follows:

- (1) The proposed exchanges will be treated as tax free exchanges under § 1035; and
- (2) Upon completion of the proposed exchanges, the basis and the investment in the contract of the new policies issued by Companies 1 and 3 will be the same as Taxpayer's basis and investment in the contract in the exchanged policies.

With respect to the first issue, the Service pointed out that the legislative history of Section 1035, which permits the tax-free exchange of a contract of life insurance for another contract of life insurance insuring the same life, indicates that section 1035 was designed to eliminate the taxation of individuals "who merely exchanged one insurance policy for another better suited to their needs but who have actually recognized no gain." The Service further noted that the certificates issued for a single insured pursuant to a group account COLI policy are treated as separate contracts for purposes of state insurance laws, and that Taxpayer does treat each certificate issued under the group account COLI policies as a separate contract for purposes of the Internal Revenue Code. Further, all of the newly issued COLI contracts exchanged for the original MECs will also be MECs, and Taxpayer will not make any material increase in the death benefit or other material change. In these circumstances, the provisions of Section 1035(a)(1) are applicable, and the exchanges will be tax-free.

On the second issue, the Revenue Service reasoned that Section 1035 references section 1031 for the rules to determine the basis of property acquired in a section 1035 exchange. Under Section 1031(d), property acquired in a section 1035 exchange has the same basis as that of the property exchanged, decreased by the amount of any money received [in this case none] by the taxpayer and increased by any gain (or decreased by any loss) recognized by the taxpayer on the exchange [also zero in this case].

In our Bulletin No. 07-43 (discussing PLR 200715006), we noted that, since these exchanges and certain other exchanges of individual COLI policies for new individual COLI policies on the lives of the same employees meet the requirements of Section 1035, then Sections 101(j) and 6039I, as added by the Pension Protection Act of 2006 (see our Bulletins Nos. 06-121, 06-127, 06-132 and 07-17) will not apply to the proposed exchanges, and the Revenue Service so ruled in PLR 200715006.

Any AALU member who wishes to obtain a copy of PLR 200801001 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at [www.aalu.org](http://www.aalu.org) and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at [ruselowski@aalu.org](mailto:ruselowski@aalu.org) and include a reference to this *Washington Report*.

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