



Preserving a Life Insurance Policy Tax Loss

The Challenge

A 69 year old female client needs income for life. She wants to use a life insurance policy's cash value to supplement retirement income. The life policy's basis is \$100,000.00, but the cash value is only \$3,000.00.

The client owned a life insurance policy into which she had paid \$100,000.00 in premiums but which was worth only \$3,000.00 (with no policy loans). It was within two months of lapsing, and she no longer needed the coverage. She wanted to surrender the policy and use another \$100,000.00 she had in the bank to buy a SPIA. She reasoned that there was no need to do a 1035 exchange because the policy had no gain to preserve.

The \$100,000.00 SPIA with installment refund she was planning to buy would pay \$635.00 per month for life. \$208.00 of each payment would be taxed as ordinary income until she reached life expectancy. Thereafter, the entire payment would be taxed. At her combined 36% federal and state income tax bracket she would net \$560.00 per month. Can she get a better result? Yes, she could.

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How The Business Was Placed

Her Advisor suggested an exchange instead of a surrender. By exchanging her life insurance policy into the SPIA and adding the \$100,000.00 from the bank, the purchase payment would grow by \$3,000.00 and the annuity payments by \$19.00 per month to \$654.00. More importantly, though, the annuity cost basis would increase to \$200,000.00, and the exclusion ratio would rise to 100%. The client would get each annuity payment income tax-free (until basis was fully returned in almost 25 ½ years).

The Result

It's unfortunate that the client's life insurance policy performed so poorly. But not making the most of the policy's losses would have been worse. By structuring this transaction as an exchange instead of a surrender, the client increased her after-tax income by \$94.00 each month. Over the course of the SPIA's more than 13-year installment refund period that amounts to almost \$15,000.00 more the she (or her beneficiary) would have otherwise had.

FOR MORE INFORMATION ON EXCHANGES CONTACT:



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