PACIFIC LIFE

1035 EXCHANGES

THE POTENTIAL TO IMPROVE OUTCOMES FOR CLIENTS

Section 1035 is a provision of the Internal Revenue Code (IRC) allowing for a tax-free exchange of an existing annuity contract, life insurance policy, or endowment for a different policy or contract of like kind that better addresses a client's changing needs. These transactions are referred to as 1035 exchanges and may help improve outcomes for clients' retirement plans over time.

In other words, after careful consideration of the pros and cons, the 1035 exchange enables financial professionals to help clients swap their current insurance or investment products for similar policies or contracts without triggering taxes on any investment gains associated with the original contract. To qualify for a 1035 exchange, the contract owner or policyowner also must meet certain other requirements:

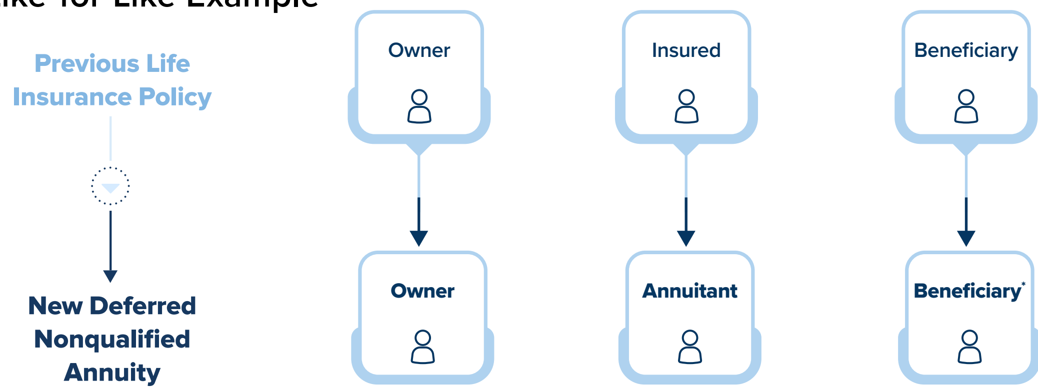
- **Types of Products:** A 1035 exchange can be applied to various financial products, including annuities, life insurance policies, products related to extended medical care, and endowments.
- **Like Kind:** The exchange must occur between products of **similar type**, such as life insurance for life insurance or a nonqualified annuity for another nonqualified annuity.
- **Exceptions:** While a life insurance policy can be exchanged for a nonqualified annuity, the reverse is not allowed. Additionally, the annuitant or policyowner must remain the same during the exchange.
- **Tax Reporting:** Although the transfer is not taxable, it is **reportable**. Individuals must report the exchange on their annual tax returns using Form 1099-R.

Under a 1035 exchange, the contract owner or policyowner cannot take constructive receipt of the funds and then use them to buy a new policy; the money must be transferred directly. Also, the exchange must be like for like, meaning it must be with the same kind of product or one of the allowable exceptions, and the owner and insured or annuitant must be the same to qualify for an exchange. For example, an annuity owned by John Doe cannot be exchanged to another annuity owned by Sandy Doe or to another annuity jointly owned by John and Sandy Doe.

Key Features of a 1035 Exchange

A 1035 exchange may allow the owner to exchange an outdated and/or underperforming product for a newer product with features that are more attractive to the client, such as a more diverse assortment of investment options, fewer restrictive provisions, and lower fees. In addition, an owner of a life insurance policy may no longer need it and would prefer to receive income instead. He or she can choose to exchange the policy for an annuity to better align with current goals and needs. Discuss clients' goals carefully to be sure 1035 exchanges would adequately serve their overall financial situations.

Like-for-Like Example

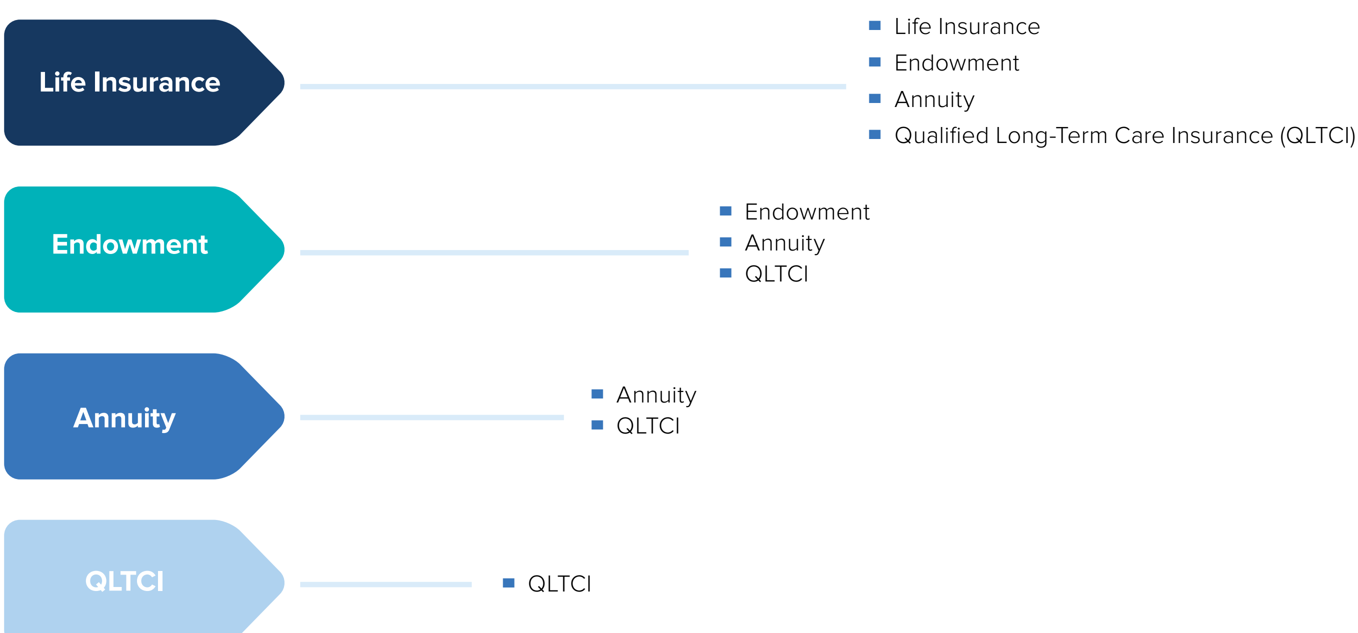


*Does not have to be the same on the old and new contract in order for the exchange to be tax-free under IRC 1035.

Allowable 1035 Exchanges

Tax-free exchanges under Section 1035 of the IRC have been around for many years, giving contract owners and policyowners the opportunity to replace contracts and/or policies that no longer serve them. If a client were to attempt to replace an old policy without opting for a 1035 exchange, any gains from the original policy would be treated as ordinary income and taxed as such. In addition, 1035 exchanges have been expanded in recent years to include beneficiary-held nonqualified deferred annuities, thus allowing a post-death exchange from one annuity to another.

The following chart illustrates allowable 1035 exchanges. It does not include post-death 1035 exchanges, which must be annuity-to-annuity.



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Partial 1035 Exchanges

Sometimes, an annuity owner will want additional income but not enough additional income to annuitize the entire contract. In this circumstance, partial annuitization may be an effective strategy.

Partial annuitization creates income payments from a portion of the nonqualified annuity. The payments will be based on the annuity factors of the existing contract and limited to the annuity payouts offered by that contract. A partial 1035 exchange creates annuity payments from a portion of a nonqualified annuity by “buying” a type of fixed annuity called a single-premium immediate annuity (SPIA). The payments will be based on several annuity factors, such as age, gender, the amount contributed, and the selected annuity income option and period offered by the SPIA. It should be noted that withdrawals from the original and new contracts can not be made for six months following the partial exchange.

Either can work. The decision is typically based on which one has the higher income or more favorable payment options for a client’s specific circumstances. Although partial exchanges are permitted with deferred nonqualified annuities, current tax laws do not allow for a partial exchange of a life insurance policy.

Is a 1035 Exchange Reportable on IRS Form 1099-R?

Yes, when a 1035 exchange is executed, the surrendering company will issue a 1099-R. The 1099-R will indicate the amount of the exchange and use distribution code “6,” indicating it is a 1035 exchange. The exchanged funds are not taxable, but it must be reported on a tax return.

Additional Considerations

Before executing a 1035 exchange, a policyowner or contract owner will want to compare the features of the existing product contract against the new product terms. It’s important to keep in mind all potential consequences of an exchange, including: losing features—such as enhanced death benefit riders or living income riders—on the existing policy or contract; gaining features on the new policy or contract; administrative fees and charges; investment choices and associated fees; contingent deferred sale charges (CDSCs); and withdrawal charges. Always be sure that the new policy or contract addresses the client’s stated objectives and supports long-term and present financial needs.

For more information, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.

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