

## 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.

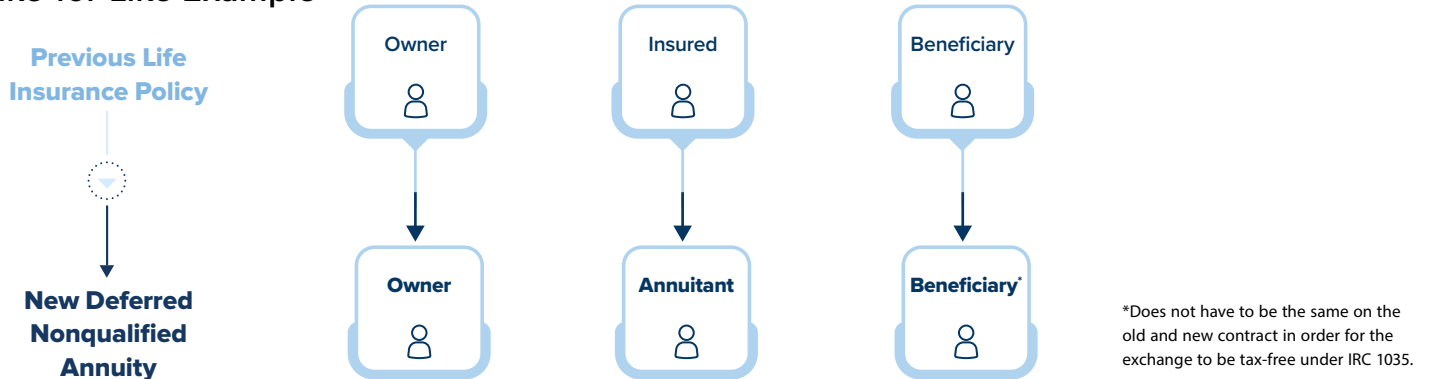
Insurance products can be issued in all states, except New York, by Pacific Life Insurance Company and in all states by Pacific Life & Annuity Company. Product/material availability and features may vary by state.

**No bank guarantee • Not a deposit • May lose value  
Not FDIC/NCUA insured • Not insured by any federal government agency**

# 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.

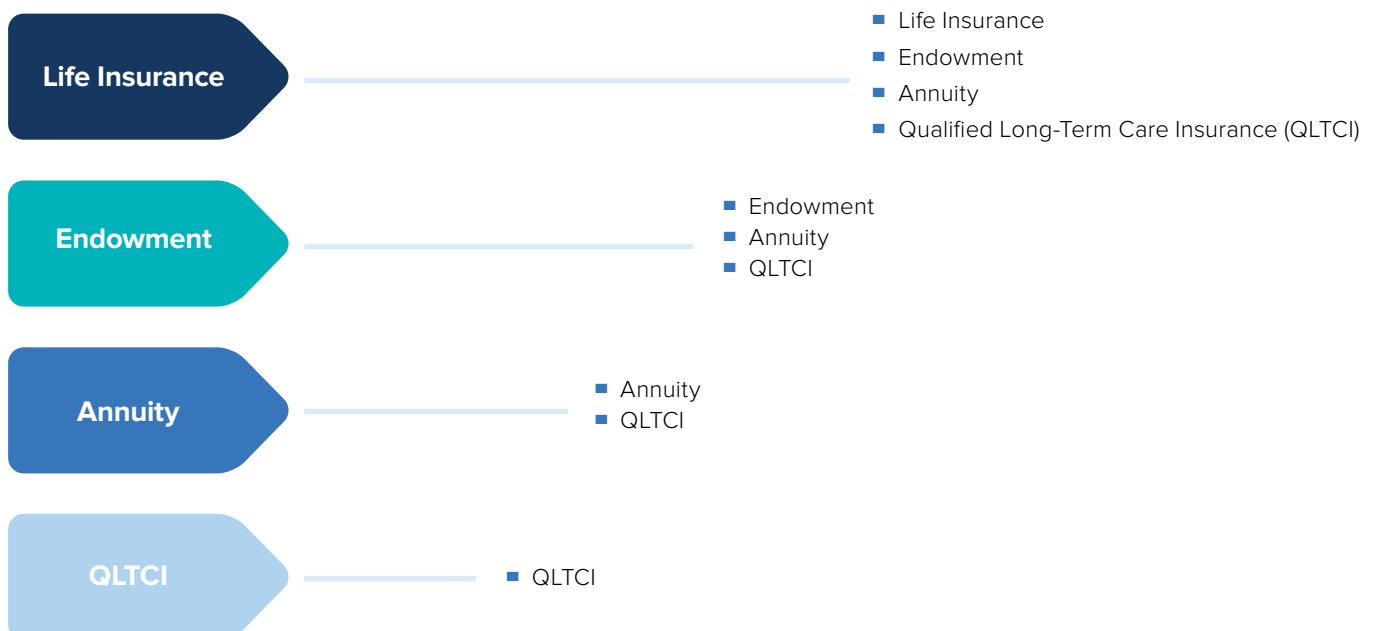
## Like-for-Like Example



## 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.



## 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  
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[Annuities.PacificLife.com](http://Annuities.PacificLife.com)

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*Pacific Life is a product provider. It is not a fiduciary and therefore does not give advice or make recommendations regarding insurance or investment products.*

There are circumstances in which replacing your client's existing life insurance or annuity can benefit your client. As a general rule, however, replacement is not in your client's best interest. You should make a careful comparison of the costs and benefits, including any applicable surrender charges, of your client's existing policy and the proposed policy to analyze how a replacement may affect your client's plan of insurance. You should provide this detailed information to your client and discuss whether replacement is in your client's best interest.

Nonqualified contracts may not be subject to the various requirements for qualified contracts, but are still subject to an additional 10% federal income tax for annuity payments, withdrawals, and other distributions prior to age 59½. While there are exceptions to this additional federal tax under IRC Section 72(q), certain payment options may not comply. For nonqualified contracts, an additional 3.8% federal tax may apply on net investment income.

Partial annuitization and withdrawals will reduce the contract value and the value of the death benefit, and also may reduce the value of any optional benefits. Partial annuitization is treated as a withdrawal and will reduce the contract value by the amount that is annuitized. Additionally, for contracts that hold an optional living or death benefit rider, partial annuitization may reduce the benefits guaranteed under the rider, depending on each rider's features and the amount that is annuitized.

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Insurance product and rider guarantees, including optional benefits and any fixed crediting rates or annuity payout rates, are backed by the financial strength and claims-paying ability of the issuing insurance company and do not protect the value of the variable investment options. They are not backed by the broker/dealer from which this annuity is purchased, by the insurance agency from which this annuity is purchased, or any affiliates of those entities, and none makes any representations or guarantees regarding the claims-paying ability of the issuing insurance company.

The home office for Pacific Life & Annuity Company is located in Phoenix, Arizona. The home office for Pacific Life Insurance Company is located in Omaha, Nebraska.

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