Miller Wealth Advisors

CASE STUDY | VOLUME 109

RECOUPING EMBEDDED LIFE POLICY LOSSES

COST BASIS OF TWO LIFE POLICIES IS PRESERVED USING A SECTION 1035 EXCHANGE

THE SITUATION

Steven Hardwick, a successful, 70-year-old lawyer, is married with two adult children. His financial condition has improved over the years to the degree that he no longer needs life insurance to provide for his family. He owns two universal life insurance policies with surrender values that are less than the total premiums paid. These “embedded losses” are generally not deductible against income taxes.

THE STRATEGY

In Section 1035 exchanges, the cost basis of a life policy can be carried over into a deferred annuity contract. These embedded losses may be used to offset either current or future gains in an annuity contract (existing or newly established). Since Steven does not own an existing nonqualified annuity, we proposed that he fund a new variable annuity using the cash surrender value of the two life policies. The type of annuity recommended is an investment-only variable annuity because it is straightforward, low-cost and offers a wide range of investment options, including alternatives.

IMPORTANT CONSIDERATIONS

- Confirm the cost basis to be transferred with the life insurance company before the exchange AND with the annuity company after the exchange.
- The owner of the annuity must be the same owner of the life policy and the annuitant should match the insured.
- The cash surrender value of the life policy must be greater than zero.

THE OUTCOME

Steven funded the new annuity with a 1035 exchange of $300,000 from his life policies. His cost basis in the two policies totaled $400,000, which carried over to the annuity. As a result of this strategy, Steven is able to preserve his embedded loss which can be used to offset future gains earned in the annuity. Additionally, Steven may want to allocate the investments in his annuity toward more growth-oriented options knowing that the first $100,000 of gains will not be taxed.

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