Insurance and Annuities

TAX-FREE POLICY EXCHANGES

Presented for

Valued Client

Presented by

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TAX-FREE POLICY EXCHANGES

The Rationale…

- As life insurance policies evolve, improvements in policy design have enhanced flexibility, rate of return and price.
- As a result, some consumers find it attractive to exchange old policies for new and improved models.
- Section 1035 of the Internal Revenue Code lets consumers defer taxation of accumulated gain when exchanging an old policy for a new one—as long as certain requirements are met.
- When policyowners meet Section 1035 requirements, they need not recognize a taxable gain when exchanging:
  - A life insurance policy for another life insurance policy, annuity, endowment contract, or qualified long-term care insurance contract.
  - An endowment contract for another endowment contract providing for regular payments beginning no later than the payments prescribed under the old contract, an annuity, or a qualified long-term care insurance contract.
  - An annuity contract for another annuity contract, or for a qualified long-term care insurance contract.
  - A qualified long-term care insurance contract for another qualified long-term care insurance contract.

The Requirements…

- The new life insurance policy must insure the same life as the old policy.
- A policy on one life may not be exchanged for a policy on two lives.
- A new annuity contract must have the same payee as the old contract.
- If cash or other consideration is part of the exchange, the transferor recognizes any gain in the policy up to the amount of cash or other consideration received. This gain is taxable as ordinary income. Existing loans that are forgiven when the exchange is made are considered income to the lesser of the gain or the loan.
- Generally, the income tax basis of the old policy carries over to the new policy.

TAX-FREE POLICY EXCHANGES

The Caveats…

- The policyowner or agent should examine certain “red flags” before carrying out a 1035 exchange.
- **Insurability**—Do not terminate an old policy before determining current insurability and the rates for new coverage.
- **Tax benefits**—Determine if the old policy enjoys any tax advantages that aren’t available in the new policy.
- **Policy loans**—Understand that outstanding loans on the old policy can complicate the policy exchange and possibly cause the transaction to be taxed.

The Bottom Line…

Exchanging older policies for new ones can make sense in many cases. As long as certain requirements are met, Section 1035 of the Internal Revenue Code allows for such exchanges without producing a taxable gain. However, it is advisable to consult a tax advisor before executing a 1035 exchange.

TAX-FREE POLICY EXCHANGES

SUMMARY

What Are Tax-Free Policy Exchanges?

Exchanging an old policy for a newer one is a frequent occurrence, often motivated by a desire to obtain a higher rate of return, lower mortality costs or additional policy features.

In buying a new policy, a consumer incurs new acquisition costs, which may mean that even a clearly superior new policy may not be a better deal until several years have passed. However, for owners of older policies, Section 1035 of the Internal Revenue Code helps by letting consumers defer federal income taxation of the gain in older policies when they're exchanged for new ones, provided certain requirements are met. A Section 1035 exchange also transfers the basis of the existing policy to the new policy.

But there are caveats. Policyowners should consider the pros and cons and carefully compare existing coverage with reasonable projections of new policy values and benefits before making an exchange.

How Do Tax-Free Policy Exchanges Work?

When the policyowner meets Section 1035 requirements, no gain or loss will be recognized on the exchange of the old policy for the new one. Specifically, the exchange must be:

- A life insurance policy for another life insurance policy, annuity, endowment contract, or qualified long-term care insurance contract.
- An endowment contract for another endowment contract providing for regular payments beginning no later than the payments prescribed under the old contract, an annuity, or a qualified long-term care insurance contract.
- An annuity contract for another annuity contract, or for a qualified long-term care insurance contract.
- A qualified long-term care insurance contract for another qualified long-term care insurance contract.

To qualify as a tax-free Section 1035 exchange, an actual exchange of policies generally must take place. Policyowners should carefully follow insurance company procedures and are encouraged to consult a tax advisor.

What If the Old Policy Has an Outstanding Loan?

Another caveat: Section 1031(b) of the Internal Revenue Code provides that gain from exchanges "not solely in kind" will be taxable. Therefore, when the policy being exchanged has an outstanding loan, the loan amount that is paid off during the exchange is taxable up to the amount of gain in the contract.

The most common way to avoid a taxable gain is to pay off the policy loan prior to the exchange. Alternately, it is sometimes possible to have the new policy subject to the same loan amount as the old policy.

Policy exchanges can be useful in many cases, but consumers are encouraged to consult their tax advisors—especially when a policy loan is involved.

TAX-FREE POLICY EXCHANGES

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