Tax-Free Policy Exchanges

IRC Sec. 1035

In some situations, it may be advantageous to exchange an older policy for a new one. Through what is known as a “tax-free” exchange, federal income tax law[1] allows a policy holder to defer the gain on an old policy at the time it is exchanged for a new policy. The table below shows the situations to which this tax-free exchange provision applies:

Policies Which Can Be Exchanged Tax-Free

From This ⇩	To This⇨	Type of New Contract			
		To Life Insurance	To an Endowment Contract	To a Fixed or Variable Annuity	To a Qualified Long-Term Care Contract
Life insurance		Yes	Yes	Yes	Yes
Endowment contract		No	Yes[2]	Yes	Yes
Annuity contract[3]		No	No	Yes	Yes
Qualified long-term care contract		No	No	No	Yes

Key Points

- Life policies must be on the life of same person.[4]
- Annuity contracts must be payable to the same person(s).
- When contracts are assignable, there should be a direct transfer of funds between insurance companies.[5]

[1] The discussion here concerns *federal* income tax law. State or local income tax law may differ.

[2] Provided payments begin no later than under the old contract. Endowment Contracts must meet the definition of life insurance.

[3] See Revenue Procedure 2011-38 for IRS guidance on the federal income tax treatment of partial annuity exchanges, applicable to transfers completed on or after October 24, 2011. For partial annuity exchanges completed on or after June 30, 2008 and before October 24, 2011, the guidance provided in Revenue Procedure 2008-24 generally applies.

[4] A single policy may not be exchanged for one on multiple lives, (e.g., a second-to-die policy.) See PLR 9542037

[5] Some exceptions for troubled insurers. Rev. Proc. 92-44 and 92-44A

- The cost basis of the old policy (including certain riders and/or rating) is carried over to the new policy.
- If cash or other property is part of the exchange, any gain will be recognized up to that amount.
- A permanent policy with an outstanding loan can be exchanged for another similar policy with the same indebtedness. If the indebtedness is reduced in the exchange, there will be income tax consequences.
- If there is a recognized gain, it is ordinary income.

Potential Problems

The early surrender of certain life insurance policies or annuity contracts may have significant, negative consequences. For example, a policy or contract owner may be required to pay a surrender charge, there may be tax penalties due, or the owner may receive less than he or she originally invested or paid into the contract.

Questions to Consider

- Determine whether the incontestability period and suicide provisions are based on the issue date of the new policy or the old one.
- Consider the rating of the new company.
- Determine whether the old policy has favorable tax status which would not transfer to the new policy.
- Determine whether the premium on the new policy will be more expensive. This may happen, for example, because of changes in health.

An experienced life insurance professional is an important guide through this process. Make certain you are medically insurable before the old policy is terminated and that there is not a period during the exchange when you have no coverage.