What Is a 1035 Exchange?

Named after Section 1035 of the Internal Revenue Code, a 1035 exchange allows life insurance policy owners (and annuity contract owners) to exchange an old policy (or contract) for a new one from a different insurance company without tax consequences. Of course, the exchange must meet the requirements of Section 1035 in order for the transaction to be tax-free. This strategy can be especially beneficial to a person who purchased a life insurance policy or annuity contract many years ago that has less favorable contract stipulations than those available today.

A 1035 exchange applies only when it involves the same contract holder and the same type of contract. It gives the contract owner the flexibility to find another contract that features lower costs, a higher death benefit, or more investment choices. The cost and availability of insurance depend on factors such as age, health, and the type and amount of insurance purchased. Before surrendering your "old" life insurance policy, it would be prudent to make sure that you are insurable.

Investors can also do partial 1035 exchanges for a portion of the total contract amount. In this case, the transferring company should notify the new company of the exchange amount that is investment versus gain, because any gain is subject to ordinary income taxes when withdrawn. Some companies do not recognize partial 1035 exchanges for tax reporting purposes. A tax professional should be consulted to properly track these amounts in the contract.

Nonetheless, a 1035 exchange can be an effective tool for contract holders who want to exchange older contracts for current, more useful ones.

The rules governing 1035 exchanges are complex, and you may incur surrender charges from your “old” annuity contract or life insurance policy. In addition, you may be subject to new sales, mortality and expense charges, and surrender charges for the new contract or policy.

Annuities have contract limitations, fees, and charges, which can include mortality and expense risk charges, sales and surrender charges, investment management fees, administrative fees, and charges for optional benefits. Annuities are not guaranteed by the FDIC or any other government agency; they are not deposits of, nor are they guaranteed or endorsed by, any bank or savings association. Any guarantees are contingent on the financial strength and claims-paying ability of the issuing insurance company. Withdrawals reduce annuity contract benefits and values. The investment return and principal value of an investment option are not guaranteed. Because variable annuity subaccounts fluctuate with changes in market conditions, the principal may be worth more or less than the original amount invested when the annuity is surrendered.

Variable annuities are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity contract and the underlying investment options, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

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