Does tax liability arise when a policyholder exchanges one life insurance contract for another one?

The IRC provides that the following are *nontaxable* exchanges: (1) the exchange of a life insurance policy for another life insurance policy, for an endowment or annuity contract, or for a qualified long-term-care insurance contract, (2) the exchange of an endowment contract for an annuity contract, for an endowment contract under which payments will begin no later than payments would have begun under the contract exchanged, or for a qualified long-term-care insurance contract, (3) the exchange of an annuity contract for another annuity contract or for a qualified long-term-care insurance contract, and (4) the exchange of a qualified long-term care insurance contract for another qualified long-term care insurance contract.[[1]](#footnote-1) These rules do not apply to any exchange having the effect of transferring property to any non-U.S. person.[[2]](#footnote-2)

If an exchange involves life insurance policies, the policies must be on the life of the same insured. Otherwise, the exchange does not qualify as a tax-free exchange under IRC Section 1035(a).[[3]](#footnote-3)

**Planning Point**: If a policy loan is outstanding at the time of an IRC Section 1035 tax-free exchange, the amount of the *net* reduction, if any, in the taxpayer’s outstanding loan will be considered “boot” and taxable as ordinary income at that time to the extent there is income on the contract, without regard to basis.

1. IRC Sec. 1035(a). [↑](#footnote-ref-1)
2. IRC Sec. 1035(c). [↑](#footnote-ref-2)
3. Treas. Reg. §1.1035-1. [↑](#footnote-ref-3)