Is there any tax liability when a whole life policy subject to indebtedness is exchanged for a new policy subject to the same indebtedness?

When a whole life policy with an outstanding loan was exchanged for another whole life policy subject to the same indebtedness, the exchange was treated as an entirely tax-free exchange.[[1]](#footnote-1) The IRS reached the same conclusion when one policy was exchanged for another subject to the same indebtedness and the taxpayer contemplated making withdrawals or partial surrenders from the policy to reduce the indebtedness.[[2]](#footnote-2) The cost basis of the new contract will be the cost basis of the old, plus the amount of gain recognized, minus the amount of cash or other property received (with proper adjustments for premiums paid and dividends received after the exchange).[[3]](#footnote-3)

**Planning Point: Applying a step-transaction doctrine approach, life insurance companies typically treat loans repaid within six months (or a year) after the exchange as having been extinguished at the time of the exchange. It is important to know the reporting policy of the company issuing the new policy if a quick repayment of a carry-over loan is contemplated. But, even if not reported, extinguishment of the carry-over loan shortly after issue could be regarded by the IRS as if extinguished at issue – possibly creating taxable income.**

1. Let. Ruls. 8806058, 8604033. [↑](#footnote-ref-1)
2. Let. Rul. 8816015. [↑](#footnote-ref-2)
3. IRC Sec. 1031(d); Treas. Reg. §1.1031(d)-1. [↑](#footnote-ref-3)