

Don't get stuck! How a 1035 exchange may help keep your insurance up-to-date

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When executing your overall financial plan, insurance policies and insurance-related products, such as annuities, can often be very useful tools. One specific benefit of these products is that they are often structured to be useful over long periods of time. However, their long-term utility also puts them at risk of becoming obsolete as market trends shift and products improve or are no longer appropriate as your financial needs change. Luckily, the IRS allows for flexibility if you need to move from an existing policy or annuity to newer, cheaper or more appropriate insurance products with a 1035 Exchange.

Named after the Internal Revenue Code provision, a 1035 Exchange allows for the tax-free transfer of an existing life insurance policy, endowment policy or annuity contract to a new one. This can be particularly beneficial when the new policy or contract offers better terms, lower costs or more favorable features when considering your needs and goals. The primary appeal of a 1035 Exchange is its ability to defer taxes, thus allowing the policyholder to potentially improve their existing investment or change to a more relevant one without incurring any immediate tax consequences. This tax deferral can be thought of in the same capacity as an IRA rollover, wherein the investment vehicle can be changed without taxes being realized on the transfer of dollars.

While there are countless types of insurance and annuity products, the types of allowable exchanges are not limitless. With this in mind, the following represent the most common forms of exchanges allowed by the IRS and general reasons for considering one.

Exchanging a life insurance policy to another life insurance policy

Life insurance policy owners may look to upgrade or replace an existing life insurance policy with a new one with better features, lower premiums or more appropriate coverage. A common example would be switching from a whole life insurance policy to a universal policy with more flexible premium options.

Exchanging a life insurance policy to an annuity:

If you are looking to generate retirement income and no longer needing life insurance coverage could convert the cash value of an existing life insurance policy into an annuity.

Exchanging an annuity to another annuity:

Transferring the balance of one annuity to another can allow you to gain better terms, such as lower fees, better investment options or more favorable payout structures. One example would be swapping a variable annuity with high fees for a fixed annuity with guaranteed returns and lower fees.

Exchanging a life insurance policy or annuity to a long-term care policy

Individuals seeking long term care coverage could use the cash value from an existing life insurance policy or annuity to fund a long term care or hybrid policy that offers both a death benefit and long-term care coverage.

The examples above are just a few of the many types of allowable exchanges that can help to support an individual's changing financial goals. While the tax savings and flexibility provide an attractive benefit, it's important to consider all policy details before executing a 1035 Exchange. Underlying surrender charges in an exchange, existing riders not carrying over to a new policy and differing costs associated with a new policy are just a few of the factors that could reduce the attractiveness of an exchange. Due to the complexities and tax implications involved in executing a 1035 Exchange, it's crucial that you consult with both your tax professional and your Mesirow Wealth Advisor to ensure suitability with your overall financial plan.

A 1035 Exchange can be a powerful tool to fully integrate the most appropriate life insurance or annuity contract with your overall financial plan. Policyholders have the potential to improve their overall financial health by deferring taxes and accessing better terms. However, it is crucial to carefully evaluate both the existing and new policies, understand the associated costs and seek the advice of your insurance professional and your Mesirow Wealth Advisor to ensure that an exchange aligns with your overall financial plan as your needs and goals evolve.

¹<https://www.investopedia.com/terms/s/sec1035ex.asp>

² <https://www.kiplinger.com/article/retirement/t003-c032-s014-annuity-exchanges-boost-flexibility-without-taxes.html>

³ <https://www.thebalancemoney.com/what-is-a-1035-exchange-5221495>

⁴ <https://www.finra.org/investors/insights/should-you-exchange-your-life-insurance-policy>

⁵ <https://www.thrivent.com/insights/taxes/1035-exchange-what-it-is-how-it-works>

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