

## TENZING PERSPECTIVES

### Enhancing Client Outcomes: Essential Considerations for a 1035 Exchange

A 1035 exchange is a strategic financial planning tool that allows policyholders to replace an existing life insurance policy with a new one while maintaining tax-deferred status. This provision under Section 1035 of the Internal Revenue Code offers significant opportunities for policyholders to improve their coverage, reduce costs, and enhance financial planning strategies. However, executing a 1035 exchange requires careful consideration to ensure that the transaction is in the client's best interest and adheres to regulatory standards.

For tax, legal, and wealth professionals, a deep understanding of the key conditions and regulatory implications of a 1035 exchange is essential. Improper execution can result in unintended tax consequences, increased costs, or loss of important benefits. This whitepaper outlines the critical conditions for a successful 1035 exchange and provides a structured approach to evaluating and implementing these transactions effectively.

#### Key Benefits of a 1035 Exchange

A properly structured 1035 exchange can provide several benefits, including:

**Tax-Deferral** One of the most significant opportunities of a 1035 exchange is its ability to preserve tax-deferred growth, allowing policyholders to transition from an old policy to a new one without incurring immediate tax liabilities on any accumulated gains. This is particularly beneficial for clients with policies that have

substantial cash value accumulation over time.

**Policy Improvement** Many older policies lack modern features and benefits available in today's market, such as enhanced death benefits, long-term care riders, and flexible premium options.

A 1035 exchange allows clients to upgrade their coverage to meet their evolving financial needs while potentially enhancing policy performance.

### Alignment with Financial Goals

Clients' financial objectives often change over time. A 1035 exchange enables policyholders to transition to policies that better align with their estate planning, wealth transfer, and retirement goals.

For example, a client may wish to shift from a high-cost whole life policy to a lower-cost universal life policy with a guaranteed death benefit.

### Conditions for a Successful 1035 Exchange

Executing a 1035 exchange requires thorough analysis and strategic planning. Below are the critical factors to consider:

#### *Suitability Analysis*

**Assessing Client Goals and Financial Situation** Understanding the client's reasons for considering an exchange, including changes in financial goals, estate planning needs, and liquidity requirements is foundational to a successful 1035 exchange.

Determining whether a new policy provides clear advantages over the existing policy is paramount.

**Comparing New Policy Benefits vs. Existing Policy** Suitability analysis begins with conducting a side-by-side evaluation of death benefits, premium costs, policy riders, and cash value accumulation.

Identifying potential risks associated with the transition, such as loss of guaranteed benefits or policy stability, allows clients to understand any benefits or drawbacks before deciding to replace their current policy.

**Evaluating Risk Tolerance and Underwriting Considerations** Client risk profiles change over time. Careful analysis of the client's current risk profile helps in determining a policy design that aligns with their long-term financial goals.

Consideration of underwriting factors requires assessing whether the client's health status has changed and how it may impact insurability and premium costs. For a detailed discussion of the modern underwriting landscape, refer to our Tenzing Perspectives whitepaper: [Underwriting Life Insurance for Individuals with Prior Health Issues](#).

#### *Cost-Benefit Analysis*

**Surrender Charges and Cost Structures** Identifying potential hidden costs that could erode policy value over time is key to providing clients with a clear understanding of the factors involved in the policy replacement decision.

Cost-benefit analysis should include evaluating whether an existing policy's surrender charges or other costs outweigh the benefits of exchanging to a new one.

**Premiums and Cash Value Impact** It is imperative to analyze the predictability of premiums in the new policy when comparing it to the existing policy's premium requirements.

The existing policy's cash value will fund acquisition costs and policy charges for the new policy. As a result, the cash value is usually lower after the tax-free transfer. Even if cash value accumulation is not a priority for policy owners, they should understand and consider this.

1035 Exchanges may include policy loans, which can be transferred to the new policy. The new policy's loan rate may be lower than the existing policy's rate, leading to improved performance. In certain cases, policy owners can pay off loan balances using policy values after a new policy has been in place for over a year.

**Fees, Expenses, and Potential Loss of Benefits** Consider administrative fees, policy management costs, and any loss of guarantees associated with the current policy.

#### *Underwriting and Insurability*

#### **Health Status and Impact on Pricing**

The client's health factors and insurance company underwriting results impact the suitability of a 1035 exchange. Moderate changes in clients' health since the original policy may not have a negative impact, but significant

health issues may make a new policy's pricing unattractive.

Informal underwriting allows an evaluation of the potential pricing for a replacement policy. Working with an independent life insurance team on informal underwriting through multiple carriers, positions clients for better underwriting outcomes.

When a positive result is deemed unlikely after a medical history review by insurance company underwriters, the unnecessary examination is avoided. In favorable situations, it may provide confidence that it is worth the client's time to complete an insurance examination.

**Need for Medical Underwriting** In most cases, full underwriting is necessary for policy replacement. Advising the client on the implications of a new medical evaluation within the context of the current underwriting environment is crucial. See our Tenzing Perspectives whitepaper [Obtaining Life Insurance with a Health History](#) for a client-friendly explanation of modern underwriting considerations.

#### **Carrier Stability and Financial Strength**

Selecting a financially sound and highly rated insurance carrier can significantly contribute to long-term policy viability and performance. Carriers with historically good policyholder treatment are preferred over companies whose product

portfolios have underperformed projections.

#### *Tax and Compliance Considerations*

##### **IRS Rules for Tax-Free Status Under**

**Section 1035** An experienced life insurance team ensures that proposed 1035 exchanges meet IRS requirements for maintaining tax-deferred status and avoiding unexpected tax liabilities.

1035 Exchanges require that the existing policy and the new policy have the same owner and the same insured(s). Single life policies can only be replaced via 1035 Exchange by single life policies, and survivorship policies must be replaced by survivorship policies, unless one of the insureds has died.

When life insurance is no longer desired, but a policy surrender will create a tax liability, a policy owner can complete a 1035 Exchange to an annuity. This can extend the tax deferral until values are distributed. A 1035 Exchange is not possible when replacing an annuity with life insurance.

#### *Coordination with Estate & Financial Planning*

##### **Trust-Owned Policies and Implications**

Proper structuring for trust-owned policies allows clients to avoid unintended tax consequences and help ensure that policy proceeds align with estate plans. Life insurance policies can also be used to enhance and

complement financial, retirement and charitable planning goals

#### **Real-Life Scenarios: When a 1035 Exchange Makes Sense**

##### *Case Study #1: Improving Coverage and Carrier Strength*

**Client Profile** The client was a 55-year-old male with a Preferred Plus Nonsmoker rating. He held multiple policies, including term, whole life, variable whole life, and universal life policies, for a total of \$1.5M in death benefit.

With \$1M in death benefit in a 20-year level term policy nearing the end of the term period, the client sought a solution to maintain his existing death benefit while strengthening his policy portfolio.

**Outcome** By transitioning to a no-lapse guaranteed variable universal life policy with a top-rated carrier, the client obtained a 33% increase in death benefit and increased financial efficiency without additional premium outlay.

##### *Case Study #2: Enhancing Survivorship Coverage*

**Client Profile** A married couple, male aged 66 and female aged 72, with preferred nonsmoker and super preferred nonsmoker ratings respectively, owned two whole life survivorship policies with a combined death benefit amount of \$4.6M.

**Outcome** The clients were able to more than double their death benefit with a \$10M survivorship universal life policy from a top-rated carrier, while maintaining the same premium structure, along with the added premium flexibility of a universal life product.

### *Case Study #3: Young Professional's Opportunity for Long-Term Value*

**Client Profile** A 32-year-old female with a super preferred nonsmoker rating owned a whole life policy purchased at age 19 with a \$642K death benefit.

**Outcome** The client obtained an increase of over 475% in death benefit with a \$3.75M indexed universal life policy through a top-rated carrier. With no additional premium, this exchange significantly improved her financial well-being and created long-term value.

### **Conclusion & Next Steps**

A properly structured 1035 exchange can enhance policy performance, shore up financial planning, and aid in tax-efficient wealth transfer. However, a

detailed analysis of suitability, costs, underwriting factors, and regulatory compliance is essential.

### *Guidance for Tax, Legal, and Wealth Professionals*

Partner with an experienced life insurance firm to conduct comprehensive policy reviews with clients to determine suitability. This allows for knowledgeable structuring and execution of the 1035 exchange. Be sure to stay informed of regulatory requirements to reduce risk to clients from unintended tax consequences.

### *How Tenzing Insurance Strategies Can Help*

We have a great deal of experience providing policy analysis and exchange structuring. We specialized in partnering with tax, legal, and wealth professionals to navigate analysis, underwriting, costs, and compliance.

Working with us means accessing tailored solutions that align with client objectives while helping increase benefits. To explore 1035 exchange opportunities for your clients, contact us today.

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