

EXCHANGING LIFE INSURANCE FOR AN ANNUITY:

A retirement income strategy for your clients

Does your client have an existing cash-value life insurance policy that may have served its intended protection purpose and they no longer need it?

Would a guaranteed income stream for life, now or in the future, better serve your client's retirement needs?

Did you know?

Individuals can exchange an existing life insurance policy, tax-free, to an immediate or deferred annuity under Section 1035 of the Internal Revenue Code.¹ Exchanges under Section 1035 are permitted when the contracts are exchanged "like-to-like," meaning the owner of both contracts are the same, and the annuitant on the new contract is the same as the insured on the existing policy. It also may be worth considering an exchange to multiple annuities. If the client has more than one goal in reallocating their life insurance policy, it can be fully exchanged into two annuities that best suit their needs.



Life Insurance Policy



Tax-free Exchange



Deferred Annuity



Immediate Annuity

What are some situations when a 1035 exchange to an annuity may make sense for my client?

- The life insurance policy is "underwater," meaning the client has paid premiums (i.e., cost basis) that exceed the accessible cash value
- The client wants to use the value of the life insurance policy for income that cannot be guaranteed by the life insurance policy. Some life insurance policies offer riders with guaranteed lifetime income
- The life insurance policy is a modified endowment contract (MEC). A MEC is a life insurance policy where the premiums paid exceed the allowable limit under Internal Revenue Code 7702A, making the gains taxable first before being able to access cost basis tax-free

1. <https://www.law.cornell.edu/uscode/text/26/1035>

How does the tax treatment of annuities work?

- With a deferred annuity, the client can 1035 exchange the total cash surrender value, with any existing cost basis in the life insurance policy, over to a new annuity. If distributions are taken as needed, the gains are taxable first as ordinary income and are taxable until cost basis is reached
- With an immediate annuity, the client can 1035 exchange the total cash surrender value, with any existing cost basis in the life insurance policy, to the immediate annuity to create an income stream that is taxed using an exclusion ratio. An exclusion ratio pays out the income stream at a percentage of the portion of the contract's gains and cost basis, making a portion of the payment tax-free, and a portion taxable at ordinary income, which may be more tax efficient for the client

Let's explore some examples

My client's life insurance policy is "underwater"

Lisa is 65 and has a life insurance policy that is underwater. Lisa does not need the existing life insurance policy for a death benefit anymore. What are Lisa's options and what do they look like?

Surrender the policy

Surrendering the policy will result in a tax-free return of the cash value, but a loss of the total premiums paid that cannot be claimed as a loss on an income tax return.

Take distributions from the policy

Withdrawals from the policy can only be distributed tax-free up to the cash value, even though the premiums paid exceed the cash value.

1035 the policy to an annuity

A deferred annuity with tax-deferred growth may be a way to recapture the cost basis that transfers in from the life policy, while avoiding future cost of insurance charges and other similar charges imposed under a life insurance policy.

An immediate annuity provides a guaranteed income that would be tax-free up to the transferred cost basis.

My client needs income, but their life insurance policy does not provide a guaranteed income

Claudia is 65 and has a life insurance policy but needs to create a guaranteed retirement income. Claudia does not need the existing life insurance policy for a death benefit anymore. What are Claudia's options and what do they look like?

Surrender the policy

Surrendering the policy will result in immediate taxation on all gains within the policy at ordinary income and a tax-free return of cost basis.

Take distributions from the policy

Withdrawals from the life policy will be accessible tax-free up to the cost basis first, and then gains would be taxable at ordinary income. There also is an option to take tax-free loans against the gains, which provides more tax flexibility than the annuity option. If the withdrawals and loans exceed the policy value, it may lapse, resulting in ordinary income tax on the gains. Some policies may also have limitations on what can be withdrawn and have increasing mortality costs as a client ages.

1035 the policy to an annuity

With a deferred annuity, withdrawals of gains are taxable first as ordinary income and are taxable until cost basis is reached, so for periodic distributions, the life insurance tax treatment may be more beneficial; however, the deferred annuity may offer future guaranteed income benefits.

An immediate annuity would be taxed using the exclusion ratio, while also providing a guaranteed income.

My client's life insurance policy is a MEC

Carol is 65 and has a life insurance policy that is a MEC. Carol does not need the existing life insurance policy for a death benefit anymore. What are Carol's options and what do they look like?

Surrender the policy

Surrendering the policy will result in immediate taxation on all gains within the policy at ordinary income and a tax-free return of cost basis.

Take distributions from the policy

With a MEC, withdrawals of gains are taxable first as ordinary income and are taxable until cost basis is reached.

1035 the policy to an annuity

Withdrawals from a deferred annuity are taxed the same as a MEC but may provide options for future guaranteed income.

Payments from an immediate annuity would be taxed using the exclusion ratio, while also providing a guaranteed income.



Learn More

Contact the Advanced Sales Team at advancedsales@securian.com to discuss whether one of these options might be beneficial for your client's retirement needs.

An annuity is intended to be a long-term, tax-deferred retirement vehicle. Earnings are taxable as ordinary income when distributed, and if withdrawn before age 59½, may be subject to a 10% federal tax penalty. If the annuity will fund an IRA or other tax qualified plan, the tax-deferral feature offers no additional value. Qualified distributions from a Roth IRA are generally excluded from gross income, but taxes and penalties may apply to non-qualified distributions. Please consult a tax advisor for specific information. There are charges and expenses associated with annuities, such as surrender charges (deferred sales charges) for early withdrawals.

Please keep in mind that the primary reason to purchase a life insurance product is the death benefit.

Life insurance products contain charges, such as Cost of Insurance Charge, Cash Extra Charge, and Additional Agreements Charge (which we refer to as mortality charges), and Premium Charge, Monthly Policy Charge, Policy Issue Charge, Transaction Charge, Index Segment Charge, and Surrender Charge (which we refer to as expense charges). These charges may increase over time, and these policies may contain restrictions, such as surrender periods. Policyholders could lose money in these products.

Policy loans and withdrawals may create an adverse tax result in the event of lapse or policy surrender and will reduce both the surrender value and death benefit. Withdrawals may be subject to taxation within the first fifteen years of the contract. Clients should consult their tax advisor when considering taking a policy loan or withdrawal.

This information should not be considered as tax or legal advice. Clients should consult their tax or legal advisor regarding their own tax or legal situation.

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