Financial Industry Regulatory Authority

Investor Education Series

Investor Alert

Key Topics:

- Life Insurance
- 1035 Exchanges
- Variable Products
- Tax Code

WHAT'S INSIDE

Should You Exchange Your Life Insurance Policy?

If you own a life insurance policy, you may have been approached to exchange it for another new policy. You need to know that even though the tax laws make the exchange income tax free and the new policy may appear better to you, you may be losing—not gaining—if you make the exchange. We are issuing this Alert because, increasingly, life insurance exchanges may involve variable products. Variable products are securities, and this Alert will provide information to help you evaluate whether the exchange is right for you, and how you can find out what you need to know to make an appropriate decision.

Types of Life Insurance

There are various forms of life insurance products. Although features and benefits may vary, the following is a general description of typical characteristics of various types of life insurance policies.

- **Term Life Insurance.** Term life insurance provides coverage for a specified and limited period of time (the "term"). Premiums for most term policies increase with age or at the end of each renewal period. After the policy or term ends, there is no benefit payment if the insured person survives beyond the policy period.
- **Whole Life Insurance.** Whole life or ordinary life insurance is a form of permanent life insurance. This means it can provide coverage for the life of the insured. It also can build cash value, which is a savings feature. Premium payments typically remain level for the life of the insured.
- **Universal Life Insurance.** Universal life insurance can also provide coverage for the life of the insured while at the same time providing flexibility in premium payments and in insurance coverage. The cost of insurance protection and, in some cases, other costs are deducted from the cash or policy account value.
- **Variable Life Insurance.** Variable life insurance, a variation of whole life insurance, offers a fixed premium schedule and a minimum death benefit. But it differs from traditional whole life insurance in that cash values are invested in portfolios of securities in an account separate from the general assets of the insurance company. A policyholder has discretion in choosing the mix of investments the policy offers. The insurance company does not guarantee investment returns and your cash value will fluctuate.

- **Variable Universal Life Insurance.** Variable universal life insurance combines features of universal life insurance and variable life insurance.

Information. Most variable life insurance policies and variable universal life insurance policies are securities registered with the Securities and Exchange Commission (SEC). Registration requires that investors receive important financial and other significant information concerning the securities being offered for sale. This enables investors to judge for themselves if the securities are a good investment. These regulations also provide important remedies to investors if they can prove that there was incomplete or inaccurate disclosure of important information provided to them.

1035 Exchanges

The Internal Revenue Service allows you to exchange an insurance policy that you own for a new life insurance policy insuring the same person without paying tax on the investment gains earned on the original contract. This can be a substantial benefit. Because this is governed by Section 1035 of the Internal Revenue Code, these are called "1035 Exchanges."

Alert. But this benefit comes with some important strings.

- The tax code says that the old insurance policy must be exchanged for a new policy– you cannot receive a check and apply the proceeds to the purchase of a new insurance policy.
- The tax code also says that you can make a tax-free exchange from: 1) a life insurance policy to another life insurance policy or 2) a life insurance policy to an annuity. You cannot, however, exchange an annuity contract for a life insurance policy.

A transaction in which a new insurance or annuity contract is to be purchased using all or a portion of the proceeds of an existing life insurance or annuity contract is referred to as a "replacement." A 1035 Exchange is a type of replacement transaction. Although the term "1035 Exchange" is often used to describe any form of replacement activity, technically not all replacements are Section 1035 Exchanges and as a consequence are not tax-free.

Reasons to Exchange an Existing Policy

There are various reasons why a life insurance policyholder may want to replace an existing policy with a new life insurance policy. For example,

- Improved health or mortality improvements across the general population may result in insurance coverage at a lower cost.
- You may have concerns with the solvency of the insurance company that issued the original policy or with the service of the agent that sold you the policy.
- A new life insurance policy may have more desirable features or benefits.

Reasons Not to Exchange an Existing Policy

There are also various reasons why replacement of an existing insurance policy may not be a good idea. For example:

- Cash value built up in the original policy may be applied to the new life insurance policy's first year expenses, including commissions.
- Life insurance policies (other than term policies) often include early surrender charges, which can reduce the amount of cash value available toward the new policy. The new policy will likely have its own new surrender charge schedule, which may extend beyond that of the original policy.
- You may pay higher premiums if, for example, your health has declined since the purchase of the current policy.

- The new policy typically will have a new contestability period—a two-year period from the issuance of the new policy during which the insurance company could challenge a death claim based upon a misstatement on the application.
- There may be unfavorable tax consequences caused by surrendering an existing policy, such as a potential tax on outstanding policy loans.

What You Should Watch For

Smart Thinking. You should exchange your life insurance policy only when you determine, after knowing all of the facts that the exchange is better for you and not just better for the person who is trying to sell the policy to you.

Both variable life insurance and variable universal life insurance are securities. Those who offer these products must follow SEC, FINRA, and state securities regulations, in addition to state insurance law. This means that a broker must tell you the important facts about the pros and cons of the exchange. Your broker or insurance agent should recommend such an exchange only if it is in your best interest and only after evaluating your personal and financial situation and needs, tolerance for risk, and the financial ability to pay for the proposed insurance policy.

Your broker or insurance agent may recommend that you use insurance policy values, such as loans or withdrawals, to pay premiums for a new life insurance policy. This activity is generally called "financing" premiums. It may not be appropriate for you. For example, withdrawals from existing policies may be subject to federal income tax and may reduce the death benefit. Borrowing money from an existing policy will almost certainly reduce the death benefit. Withdrawals or loans may make it more difficult to keep the original policy in force without additional out-of-pocket premium payments. If you can't keep the original policy in force, you will lose the insurance protection and the loans themselves may give rise to tax consequences.

Remember for a transaction to qualify as a 1035 exchange, the old policy must actually be exchanged for the new policy. Many states and brokerage firms require forms to reflect customer acknowledgement of a replacement transaction. These forms typically are signed by the insurance policy owner and the broker or agent. These forms may provide a comparison of the features and costs of an existing policy to a proposed policy, and point out what you need to focus on when considering an exchange. Some brokerage firms may provide brochures or educational material designed to outline the possible advantages and disadvantages of the transaction. You should review these forms and materials closely.

Good idea. Regardless of whether such forms are provided, you should specifically ask the person recommending that you exchange or replace your existing policy to provide you with illustrations for your existing policy and the new policy. You should also ask:

- **What is the total cost** to me of this exchange?
- **What are the new features** being offered? Why do I need those features?
- Are these **features worth the cost**?
- Can the **existing policy be modified or supplemented** to provide some or all of these same features?
- **Will you be paid a commission** for the exchange, and if so, how much is it?

You should not sign any exchange form or agree to exchange or purchase an insurance policy until you study all of the options carefully, have all of your questions answered, and are satisfied that the exchange is better than keeping your current policy.

If You Have Questions or Complaints

If you have questions or complaints about a life insurance policy exchange, contact:

- FINRA: *www.finra.org/complaint*
- SEC: *www.sec.gov/complaint.shtml*
- State securities administrator: *www.nasaa.org*
- State insurance commissioner: *www.naic.org*

More Information

For additional information, the following resources are available at *www.finra.org*:

- *Notices to Members 99-35* and *00-44*
- Investor Alert: *Should You Exchange Your Variable Annuity?*
- *SEC Variable Annuities: What You Should Know*
- Press Release: *NASD Regulation Files Six Enforcement Actions Involving Marketing and Sales of Variable Annuities*
- Press Release: *NASD Regulation Announces Two Enforcement Actions Involving Sales of Variable Annuity and Life Insurance Contracts*

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Website: *www.finra.org/investor*
Phone: (202) 728-6964

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Website: *www.finra.org/marketdata*

FINRA BrokerCheck—Check the background of a broker or brokerage firm.

Website: *www.finra.org/brokercheck*
Toll-free: (800) 289-9999

FINRA Investor Complaint Center—If you feel you've been treated unfairly.

FINRA Investor Complaint Center
9509 Key West Avenue
Rockville, MD 20850-3329

Website: *www.finra.org/complaint*
Fax: (866) 397-3290

FINRA Dispute Resolution—If you seek to recover damages.

FINRA Dispute Resolution
One Liberty Plaza
165 Broadway, 27th Floor
New York, NY 10006

Website: *www.finra.org/ArbitrationMediation*
Phone: (212) 858-4400
Fax: (212) 858-4429

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