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How Can I Upgrade My Insurance: Tax-Free?

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Responding to the changing needs of consumers, the life insurance industry has developed some alternatives that go much further in satisfying a variety of financial needs and objectives than some of the more traditional types of insurance and annuities.

Advancements

Modern contracts offer much more financial flexibility than traditional alternatives do. For example, universal life and variable universal life insurance policies allow policy owners to adjust premiums and death benefits to suit their financial needs.

Modern contracts can also provide much more financial control. Whereas traditional vehicles, such as whole life insurance and fixed annuities, provide returns that are determined by the insurance company, newer alternatives enable clients to make choices that help determine returns. For example, variable annuities and variable universal life insurance allow investors to allocate premiums among a variety of investment subaccounts, which can range from conservative choices, such as fixed-interest and money market portfolios, to more aggressive, growth-oriented portfolios. Returns are based on the performance of these subaccounts.

There are contract limitations, fees, and charges associated with variable annuities and variable universal life insurance, which can include mortality and expense risk charges, sales and surrender charges, investment management fees, administrative fees, and charges for optional benefits. Withdrawals reduce annuity contract benefits and values. Variable annuities and variable universal life insurance are not guaranteed by the FDIC or any other government agency; they are not deposits of, nor are they guaranteed or endorsed by, any bank or savings association. Any guarantees are contingent on the claims-paying ability of the issuing company.

Withdrawals of annuity earnings are taxed as ordinary income and may be subject to surrender charges plus a 10% federal income tax penalty if made prior to age 59½. The investment return and principal value of an investment option are not guaranteed. Because variable annuity subaccounts fluctuate with changes in market conditions, the principal may be worth more or less than the original amount invested when the annuity is surrendered.

The cash value of a variable universal life insurance policy is not guaranteed. The investment return and principal value of the variable subaccounts will fluctuate. Your cash value, and perhaps the death benefit, will be determined by the performance of the chosen subaccounts. Withdrawals may be subject to surrender charges and are taxable if you withdraw more than your basis in the policy. Policy loans or withdrawals will reduce the policy's cash value and death benefit and may require additional premium payments to keep the policy in force.

There are differences between variable- and fixed-insurance products. Variable universal life insurance offers several investment

subaccounts that invest in a portfolio of securities whose principal and rates of return fluctuate. Also, there are additional fees and charges associated with a variable universal life insurance policy that are not found in a whole life policy, such as management fees. Whole life insurance offers a fixed account, generally guaranteed by the issuing insurance company.

A Dilemma

So what should you do if you want to cash out of your existing insurance policy or annuity contract and trade into one that better suits your financial needs, without having to pay income taxes on what you've accumulated?

One solution is the "1035 exchange," found in Internal Revenue Code Section 1035. This provision allows you to exchange an existing insurance policy or annuity contract for a newer contract without having to pay taxes on the accumulation in your old contract. This way, you gain new opportunities for flexibility and tax-deferred accumulation without paying taxes on what you've already built up.

The rules governing 1035 exchanges are complex, and you may incur surrender charges from your old policy or contract. In addition, you may be subject to new sales and surrender charges for the new policy or contract. It may be worth your time to seek the help of a financial professional to consider your options.

Variable annuities and variable universal life insurance are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity and variable universal life contract and the underlying investment options, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

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