

Premier analysis of federal legislative and regulatory developments for the nation's 2,000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.

Counsel

Buchanan Ingersoll & Rooney PC *PricewaterhouseCoopers*
Gerald H. Sherman William Archer
Stuart M. Lewis Donald Carlson
Deborah M. Beers

Keith A. Mong *Ricchetti, Inc.*
Steve Ricchetti
Jeff Ricchetti

Federal Policy Group *Arnold & Porter LLP*
Ken Kies Martha L. Cochran
Matthew Dolan David F. Freeman, Jr.

AALU

David J. Stertz, *Chief Executive Officer*
Marc R. Cadin, *Senior VP of Legislative Affairs*
Chris Morton, *Vice President of Legislative Affairs*
Tom Korb, *Vice President of Policy & Public Affairs*
Sarah Spear, *Director of Policy & Public Affairs*
Anthony Raglani, *Asst. Dir. of Policy & Public Affairs*

101 Constitution Avenue NW, Suite 703 East
Washington, DC 20001
Toll Free: 1-888-275-0092 Fax: 202-742-4479
www.aalu.org

AALU Bulletin No: 10-98

October 8, 2010

Subject: **Transfer of Portion of Annuity Contract in Exchange for Another Annuity Is Tax-Free Under IRC § 1035**

Major References: [PLR 201038012](#)

Prior AALU Washington Reports: 08-30; 08-09; 03-67; 99-8; 99-42; 99-112

MDRT Information Retrieval Index Nos.: 4400.09

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

The Internal Revenue Service has ruled, based on the guidelines it adopted in Rev. Proc. 2008-24, 2008-13 I.R.B. 1 (see our Bulletin No. 08-30) that the transfer of a portion of the cash value of an annuity contract in exchange for another annuity contract will be treated as tax free under Internal Revenue Code section 1035 even though the taxpayer withdrew cash from the first annuity contract shortly after the exchange, because he was over age 59 ½ at the time of the withdrawal.

In *Conway v. Commissioner*, 111 T.C. 350 (1988), acq. 1999-2 C.B. xvi (see our Bulletins Nos. 99-8, 99-42 and 99-112), the Tax Court ruled that the partial exchange of one annuity contract for another qualifies as a tax-free exchange under Section 1035 because that section and the regulations thereunder require only that the exchanged contracts be of the same type (i.e., both annuities) and that the obligee under the two contracts be the same person. Although the IRS had argued against this result, in 1999 it acquiesced in the Tax Court's decision. The acquiescence was conditioned on two premises: First, all of the funds in the original contract, less any surrender fee, must remain invested in the annuity contracts after the transaction; and, second, the transaction otherwise must remain within the parameters of Section 1035.

In Rev. Proc. 2008-24, which superseded Notice 2003-67 (see our Bulletin No. 03-67), the Revenue Service provided additional guidance on the conditions under which partial exchanges would be approved. Specifically, the Rev. Proc. stated that an approved transfer would be one in which:

(a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); or

(b) the taxpayer demonstrates that one of the conditions described by § 72(q)(2)(A), (B), (C), (E), (F), (G), (H) or (J), or any similar life event (such as divorce or loss of employment), occurred between (i) the date of the transfer, and (ii) the date of the withdrawal or surrender.

PLR 201038012 applies these rules in a situation in which “Taxpayer,” who had attained the age of 59 ½ years, requested that “Company 1” transfer a stipulated amount of the cash surrender value of “Contract 1” to “Company 2,” to be allocated to an annuity contract issued by Company 2. Taxpayer intended that this transfer qualify as a “partial exchange” of Contract 1 under Rev. Proc. 2008-24.

The ruling states that, “[c]onsistent with his practice of taking annual withdraws from various accounts for gifting purposes, . . . Taxpayer [later] requested a withdrawal . . . from Contract 1.” Company 1 honored this request, but sent Taxpayer a letter stating that the withdrawal - which must have occurred within 12 months of the original transfer from Contract 1 - disqualified the earlier transfer from qualifying as a “partial exchange” under Code section 1035. Company 1 further stated its intent to report the amount withdrawn in the earlier transfer as being a distribution taxable to Taxpayer under section 72(e) of the Revenue Code.

As a result of his receipt of Company 1’s letter, Taxpayer requested a ruling that the earlier transfer from Contract 1 qualified as a tax-free exchange under Code section 1035(a).

The Revenue Service ruled that, although Taxpayer had withdrawn an amount from Contract 1 within 12 months of the date of the original transfer from that contract in exchange for Contract 2, the withdrawal occurred after the date on which Taxpayer had attained age 59 ½. He therefore met the condition described by section 72(q)(2)(A) of the Code. On this basis, the Service ruled that the original transfer qualified as a tax-free partial exchange under Code section 1035(a).

We note that the literal language of Rev. Proc. 2008-24, quoted above, states that the taxpayer must demonstrate that one of the conditions described in Code section 72(q)(2)(A), (B), (C), (E), (F), (G), (H) or (J), or any similar life event (such as divorce or loss of employment), **occurred between** (i) the date of the transfer, and (ii) the date of the withdrawal or surrender. Perhaps the fact that Taxpayer had already attained the age of 59 ½ prior to the date of the original transfer caused Company 1 to believe that the conditions of the Rev. Proc. had not been satisfied.

Any AALU member who wishes to obtain a copy of any of the items discussed in this Washington Report may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

In order to comply with requirements imposed by the IRS which may apply to the *Washington Report* as distributed or as re-circulated by our members, please be advised of the following:

THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.

In the event that this *Washington Report* is also considered to be a “marketed opinion” within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.



The mission of AALU is to promote, preserve and protect advanced life insurance planning for the benefit of our members, their clients, the industry and the general public.

For more information about how AALU’s advocacy efforts help protect your business and the advanced life insurance marketplace, visit our website at www.aalu.org, or call toll free 1-(888)-275-0092.