

Section 72.—Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

Under the facts stated below, is a direct transfer of a portion of the cash surrender value of an existing annuity contract for a new annuity contract issued by a second insurance company a tax-free exchange under section 1035 of the Internal Revenue Code. See Rev. Rul. 2003-76, page 355.

Section 1031.—Exchange of Property Held for Productive Use or Investment

Under the facts stated below, is a direct transfer of a portion of the cash surrender value of an existing annuity contract for a new annuity contract issued by a second insurance company a tax-free exchange under section 1035 of the Internal Revenue Code. See Rev. Rul. 2003-76, page 355.

Section 1035.—Certain Exchanges of Insurance Policies

26 CFR 1.1035-1: Certain exchanges of insurance policies.

(Also Part I, §§ 72, 1031.)

Exchange of a portion of annuity contract. An exchange of a portion of an annuity contract into a new annuity contract is treated as a tax-free exchange under section 1035 of the Code. Investment in the contract and basis are allocated according to cash value immediately prior to the exchange using the rules of sections 72 and 1031.

Rev. Rul. 2003-76

ISSUES

Under the facts stated below, is a direct transfer of a portion of the cash surrender value of an existing annuity contract for a new annuity contract issued by a second insurance company a tax-free exchange under § 1035 of the Internal Revenue Code? What is the basis under § 1035 and the investment in the existing contract under § 72 after the transfer? What is the basis under § 1035 and the investment in the new annuity contract under § 72?

FACTS

A owns Contract B, an annuity contract issued by Company B. A is the obligee under Contract B. A contracts with Insurance Company C to issue Contract C, a new annuity contract. A assigns 60 percent of the cash surrender value of Contract B to Company C to be used to purchase Contract C. At no time during the transaction does A have access to the cash surrender value of Contract B that is transferred by Company B to Company C and used to purchase Contract C. No consideration other than the cash surrender value of Contract B that is transferred from Company B to Company C will be paid in this transaction. The terms of Contract B are unchanged by this transaction, and Contract B is not treated as newly issued.

LAW AND ANALYSIS

Section 1035(a)(3) provides that no gain or loss shall be recognized on the

exchange of an annuity contract for an annuity contract. Section 1.1035-1 of the Income Tax Regulations provides that the exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under § 1035(a)(3) is limited to cases in which the same person or persons are the obligee or obligees under the contract received in the exchange as under the original contract.

The legislative history of § 1035 states that exchange treatment is appropriate for “individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain.” H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954). In *Conway v. Commissioner*, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. In that case, the transfer was made directly from the first insurance company to the unrelated insurance company, and none of the assets transferred in the transaction were received by the taxpayer.

Section 1035(d)(2) references § 1031 for the rules to determine the basis of property acquired in a § 1035 exchange. Section 1031(d) provides that property acquired in a § 1035 exchange has the same basis as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by any gain (or decreased by any loss) recognized by the taxpayer on the exchange.

Section 1.1031(d)-1 provides, in part, that in a § 1035 exchange the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. Section 1.1031(j)-1(c) provides that, in the case of a multiple exchange of properties, the basis of properties received is the “aggregate adjusted basis of the properties transferred,” which is then “allocated proportionately to each property received in the transaction.” *Cf.* Section 1.1031(j)-1(d) ex. 5 (the basis of a single property transferred in a non-recognition transaction is allocated on a *pro rata* basis to the two properties received in the transaction). Section 1.61-6(a) echoes the allocation rule of § 1.1031(d)-1, providing

that when a part of a larger property is sold, the basis of the entire property is equitably apportioned among the parts, and the gain realized or loss sustained on the part sold is the difference between the selling price and the basis allocated to such part.

Section § 72 governs the federal tax treatment of distributions from an annuity contract. When amounts received are not annuity payments, § 72(e)(6) defines the investment in the contract. (For purposes of § 72(b), which applies to annuity payments, § 72(c)(1) defines the investment in the contract in a similar, but not identical, manner). Section 72(e) sets forth rules regarding the tax treatment of distributions from annuity contracts. Under § 72(e)(2), distributions that are not amounts received as an annuity, including withdrawals and partial surrenders, result in income to the contract holder to the extent of the earnings in the contract and then in a recovery of the contract holder’s investment in the contract.

After completion of the transaction, A still owns original Contract B, reduced in value to reflect the cash surrender value transferred to Company C for Contract C. A also owns new Contract C. Because the funds were transferred by Company B directly to Company C, A had no access to the funds during the transaction other than in the form of annuity contracts. Therefore, the transfer of a portion of Contract B to Company C for new Contract C is a tax-free exchange under § 1035. The continued existence of Contract B with its reduced cash value does not affect the tax-free character of the exchange.

Under § 1035(d), A’s basis in Contract B immediately before the exchange is allocated ratably between Contract B and Contract C based on the percentage of the cash value retained in Contract B and the percentage of the cash value transferred to purchase Contract C. A’s investment in Contract B immediately before the exchange is allocated ratably between Contract B and Contract C based on the percentage of the cash value retained in Contract B and the percentage of the cash value transferred to purchase Contract C.

HOLDINGS

(1) The direct transfer by A of a portion of the cash surrender value of Contract B

to Company C for Contract C is a tax-free exchange under § 1035.

(2) After the transaction, pursuant to § 1035, A’s basis in Contract C equals 60 percent of A’s basis in Contract B immediately before the exchange. After the transaction, A’s basis in Contract B equals 40 percent of A’s basis in Contract B immediately before the exchange.

(3) After the transaction, pursuant to § 72, A’s investment in Contract C equals 60 percent of A’s investment in Contract B immediately before the exchange. After the transaction, A’s investment in Contract B equals 40 percent of A’s investment in Contract B immediately before the exchange.

TREATMENT OF CERTAIN PARTIAL EXCHANGES

Treasury and the Internal Revenue Service (the Service) are concerned that some taxpayers may enter into a partial exchange of a portion of one annuity contract for a new annuity contract as a means of reducing or avoiding tax that would otherwise be imposed under § 72(e). On August 18, 2003, Treasury and the Service published Notice 2003-51, 2003-33 I.R.B. 361, which announced that Treasury and the Service are considering whether to exercise the authority granted under § 72(e)(11) to promulgate regulations that would prescribe the tax treatment of these transactions. Notice 2003-51 provides interim guidance regarding the tax treatment of these transactions. Finally, Notice 2003-51 requests comments regarding the appropriate application of § 72(e)(11) to these transactions. Taxpayers should review Notice 2003-51 prior to entering into a partial exchange to determine whether their transaction is subject to the interim guidance provided by the notice.

DRAFTING INFORMATION

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