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RAMartin

1999-016
November 22, 1999
Attachment 1

ACTION ON DECISION

SUBJECT: Conway v. Commissioner
111 T.C. 350 (1998)
T.C. Dkt. No. 22257-96

Issue:

Whether a taxpayer's partial surrender of an annuity contract and direct transfer of the resulting proceeds for the purchase of a new annuity qualifies as a nontaxable exchange under I.R.C. § 1035?

Discussion:

In 1992, Taxpayer purchased an annuity contract from Fortis Benefits Ins. Co. (Fortis) for the amount of \$195,643. In 1994, the taxable year at issue, petitioner requested that Fortis withdraw \$119,000 from the annuity contract and issue a check to Equitable Life Ins. Co. of Iowa (Equitable) for the purpose of purchasing a new annuity contract from Equitable. Fortis mailed the check directly to Equitable. The Tax Court concluded that the transaction was a nontaxable exchange pursuant to section 1035. Consequently, the 10-percent penalty under section 72(q), which generally applies to taxable distributions from an annuity, was not applicable to the transaction.

Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity contract. See also Treas. Reg. § 1.1035-1(c). The legislative history underlying section 1035 reflects that section 1035 was fashioned to eliminate the taxation of 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, 83rd Cong., 2d Sess. 81 (1954). In this regard, the Tax Court in reaching its conclusion in this case explained that "[Taxpayer's] funds ... remain invested in a similar annuity contract, and [Taxpayer] has not personally received use or benefit of these funds since they were originally invested in the Fortis annuity contract in 1992." We agree with the court that as long as all of the funds in the original contract, less any surrender fee, remain invested in annuity contracts after the transaction, and, as long as the proceeds at all times during the transaction remained invested in annuity contracts, the transaction was within the parameters of section 1035.

The Service will continue to challenge transactions in cases where taxpayers enter into a series of partial exchanges and annuitizations as part of a design to avoid application

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of the section 72(q) ten percent penalty, or any other limitation imposed by section 72. In such cases, the Service will rely upon all available legal remedies to treat the original and new annuity contracts as one contract. Since the instant case did not involve a design to avoid application of section 72, we acquiesce to the decision of the Court.

Recommendation:

Acquiescence

Reviewers:

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By: _____
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