

Part I

Section 1035.--Certain Exchanges of Insurance Policies

26 CFR 1.1035-1: Certain exchanges of insurance policies.
(Also Part I, §§ 72, 1031)

NOTICE 2003-51

SECTION 1 – PURPOSE

This Notice addresses the taxation of certain tax-free exchanges of annuity contracts under § 72(e) and § 1035 of the Internal Revenue Code. This Notice announces 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. This Notice provides interim guidance regarding the tax treatment of these transactions. Finally, this Notice requests comments regarding the appropriate application of § 72(e)(11) to these transactions.

SECTION 2 - BACKGROUND

Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for another 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 where 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) cross-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. Revenue Ruling 2003-76, 2003-33 I.R.B. ___, addresses a transaction in which a taxpayer transfers a portion of the cash value of an existing contract to a new insurance company in exchange for a new annuity contract (commonly referred to as “partial exchanges”). Rev. Rul. 2003-76 holds that the basis under § 1031 and investment in the contract under § 72 of the surviving contract immediately before the exchange is allocated ratably between the surviving contract and the newly issued contract.

Section 72(e) governs the federal tax treatment of distributions from an annuity contract. Section 72(e)(11) provides anti-abuse rules applicable to transactions governed by § 72(e). Section 72(e)(11)(B) grants the Secretary broad authority to publish regulations as necessary “to prevent avoidance of the purposes of [§ 72(e)].”

Section 72(q)(1) imposes a 10 percent penalty on withdrawals from, or surrenders of, annuity contracts. Section 72(q)(2) provides that distributions from an annuity contract will not be subject to the 10 percent penalty if the distribution is made after the taxpayer attains age 59-1/2, if the distribution is made on or after the death of the annuity holder, if the distribution is attributable to the taxpayer’s becoming disabled, or if other conditions not relevant here are satisfied.

SECTION 3 - TREATMENT OF CERTAIN PARTIAL EXCHANGES

Treasury and the IRS are concerned that some taxpayers may enter into a transaction similar to the transaction at issue in Conway (commonly referred to as a “partial exchange”) to reduce or avoid the tax that would otherwise be imposed by § 72(e)(2). For example, if a taxpayer withdraws \$100 from an annuity contract with a cash surrender value of \$200 and investment in the contract of \$80, the entire \$100 of the withdrawal would be included in income pursuant to § 72(e)(2). However, if that same taxpayer assigned 50 percent of the cash surrender value of the annuity contract in a partial exchange, such that the cash surrender value of each contract after the exchange was \$100 and the investment in each contract after the exchange was \$40, and then surrendered either the existing annuity contract or the new annuity contract, under § 72(e)(2) only \$60 would be included in income and \$40 would be excluded as a return of investment in the contract.

Treasury and the Service are considering whether to exercise the regulatory authority of § 72(e)(11) to address the transaction described above to assure that such transactions do not become a vehicle for avoiding the rules of § 72(e). In particular, Treasury and the Service are considering whether such regulations should provide rules for determining when a partial exchange of an annuity contract followed by the surrender of, or distributions from, either the surviving annuity contract or the new annuity contract should be presumed to have been entered into for tax avoidance purposes. Specifically, Treasury and the Service are considering whether to treat surrenders or distributions that occur within 24 months of the date on which the partial

exchange was completed as presumptively entered into for tax avoidance purposes. However, Treasury and the Service believe that taxpayers should be provided the opportunity to rebut any presumption by demonstrating that the surrender or withdrawal was not contemplated at the time the partial exchange was completed. Treasury and the Service are considering whether to treat any surrender or distribution that is not subject to the 10 percent penalty tax imposed by § 72(q)(1) because it is described in § 72(q)(2) as successfully rebutting any presumption. In addition, Treasury and the Service are considering whether other events, such as the safe harbors set forth in § 1.121-3T(e), for divorce, loss of employment and other similar events, should be treated as successfully rebutting any presumption.

SECTION 4 - INTERIM GUIDANCE

Pending the publication of final regulations, the Service, using general principles of tax law, will consider all the facts and circumstances to determine whether a partial exchange and a subsequent withdrawal from, or surrender of, either the surviving annuity contract or the new annuity contract within 24 months of the date on which the partial exchange was completed should be treated as an integrated transaction, and thus whether the two contracts should be viewed as a single contract to determine the tax treatment of a surrender or withdrawal under § 72(e). See Helvering v. LeGirse, 312 U.S. 531 (1941) (concluding that, in substance, annuity contracts and the life insurance contracts purchased by the taxpayer were integrated contracts). However, if a taxpayer demonstrates that one of the conditions of § 72(q)(2), or any other similar life event, such as a divorce or the loss of employment, occurred between the partial exchange and the surrender or distribution, and that the surrender or distribution was not contemplated at the time of the partial exchange, the taxpayer will not be treated as having entered into the partial exchange and the surrender or distribution for tax avoidance purposes.

SECTION 5 - REQUEST FOR COMMENTS

Treasury and the Service request comments regarding the need for regulations under § 72(e)(11) to prevent the use of partial exchange transactions as a means of avoiding the tax imposed by § 72(e). In addition, Treasury and the Service request comments regarding whether the principles outlined in Section 3 appropriately address Treasury's and the Service's concern without significantly limiting the ability of taxpayers to use partial exchanges to acquire annuity contracts that "are better suited to their needs" as contemplated by Congress. Treasury and the Service also request comments regarding any other similar transactions that any regulations under § 72(e)(11) should address.

DRAFTING INFORMATION

The principal author of this notice is Ann H. Logan of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice contact her at (202) 622-3970 (not a toll-free call).