

## Part III

### Administrative, Procedural & Miscellaneous

#### Section 1035 (Also § 72)

Rev. Proc. 2011-38

#### SECTION 1. PURPOSE

This revenue procedure addresses the tax treatment of certain tax-free exchanges of annuity contracts under § 72 and § 1035 of the Internal Revenue Code. Rev. Proc. 2008-24, 2008-1 C.B. 684, is modified and superseded.

#### SECTION 2. BACKGROUND

.01 Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity 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." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954). 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."

.02 If, in addition to an annuity contract, a taxpayer receives other property or money in exchange for a second annuity contract, then gain (if any) is recognized to the extent of the sum of money and the fair market value of other property received, but loss (if any) is not recognized to any extent. Section 1035(d)(1) (cross referencing § 1031(b) and (c)); § 1.1031(b)-1(a); § 1031(c)-1.

.03 Section 72(e) governs the federal tax treatment of any amount received under an annuity contract that is not received as an annuity if no other income tax provision applies with respect to such amount. Under § 72(e)(2), such amounts generally are taxed on an income-first basis. Section 72(e)(12) provides that all annuity contracts issued by the same company to the same policyholder during any calendar year are treated as a single annuity contract for purposes of § 72(e).

.04 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. Such a transaction is sometimes referred to as a "partial exchange." See also Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (receipt of a check under a nonqualified annuity contract and endorsement of the check to a second company as consideration for a second annuity contract treated as a distribution under § 72(e), rather than as a tax-free exchange under § 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812

(assignment of an entire annuity contract for deposit into a preexisting annuity contract treated as a tax-free exchange under § 1035).

.05 In Rev. Rul. 2003-76, 2003-2 C.B. 355, a taxpayer directly transferred a portion of the cash surrender value of an existing annuity contract (the original contract) for a new contract issued by a second insurance company. The ruling concludes that the transfer was a tax-free exchange under § 1035, and that the basis and investment in the contract for the original contract immediately before the exchange was required to be allocated ratably between the original contract and the new contract based on the percentage of the cash value transferred to purchase the new contract.

.06 Rev. Proc. 2008-24 set forth circumstances under which a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract would be treated as a tax-free exchange under § 1035. Under the revenue procedure, a transfer was treated as a tax-free exchange if no amount was withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date of the transfer, or if the taxpayer demonstrated that one of the conditions described by § 72(q)(2)(A), (B), (C), (E), (F), (G), (H), or (J) or any similar life event "occurred between" the date of the transfer and the date of the withdrawal or surrender. A transfer within the scope of Rev. Proc. 2008-24 that was not treated as a tax-free exchange under § 1035 was instead treated as a taxable distribution under § 72(e), followed by a payment for the second contract. Rev.

Proc. 2008-24 superseded interim guidance provided by Notice 2003-51, 2003-2 C.B. 362.

.07 Section 2113 of the Small Business Jobs Act, P.L. 111-240, added § 72(a)(2) of the Internal Revenue Code to provide rules for the partial annuitization of a single annuity contract. Section 72(a)(2) provides that, if any amount is received as an annuity for 10 years or more or during one or more lives under any portion of an annuity, endowment or life insurance contract-- (a) that portion is treated as a separate contract for purposes of § 72; (b) the investment in the contract generally is allocated pro rata between each portion of the contract from which amounts are received as an annuity and the portion from which amounts are not so received; and (c) a separate annuity starting date is determined with respect to each portion of the contract from which amounts are received as an annuity. The amendment applies to amounts received in taxable years beginning after December 31, 2010.

.08 Since 2008, Treasury and the Service have learned of several practical issues that diminish the effectiveness of Rev. Proc. 2008-24. For example, some taxpayers have commented that it is not clear how the "occurred between" standard should be applied with regard to several of the conditions that are enumerated in § 72(q)(2) or to similar life events. Other taxpayers have commented that the alternative characterization of a transfer that does not qualify as a tax-free exchange is unclear, and that a 12-month waiting period produces administrative difficulties in some situations where an income tax return already was filed for the year in which the transfer took place. Still others have argued

that Treasury and the Service should provide relief for payments received as an annuity under an annuity contract involved in a partial exchange. As a result of the recent amendment of § 72(a), a taxpayer may partially annuitize a single annuity contract and apply an exclusion ratio, rather than the income-first rule of § 72(e), to amounts received as an annuity under the annuitized portion of the contract.

.09 Treasury and the Service have determined that it is in the interest of sound tax administration to modify the guidance provided by Rev. Proc. 2008-24 to address these issues. Accordingly, this revenue procedure makes the following changes to Rev. Proc. 2008-24: First, the 12-month period referred to in section 4.01(a) of Rev. Proc. 2008-24 is reduced to 180 days. Second, the rule requiring that one of the enumerated § 72(q) conditions be met (or that a similar life event occur) is eliminated. Third, the limitations on amounts withdrawn from or received under an annuity contract involved in a partial exchange do not apply to amounts received as an annuity for a period of 10 years or more or during one or more lives. Fourth, the automatic characterization of a transfer as either a tax-free exchange under § 1035 or a distribution taxable under § 72(e) followed by a payment for a second contract is eliminated. Under this approach, if a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract does not meet the 180-day test described above, the Service will apply general tax principles to determine the substance, and hence the treatment, of the transfer. Thus, for example, an amount described by § 72(e)(1)(A) that is received under either the

original contract or the new contract within 180 days of the exchange may be characterized as either boot in a tax free exchange (see § 1035(d)(1) and 1031(c)) or a distribution under § 72(e).

### SECTION 3. SCOPE

.01 This revenue procedure applies to the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies.

.02 This revenue procedure does not apply to transactions to which § 72(a)(2) applies.

### SECTION 4. PROCEDURE

.01 A transfer that is within the scope of this revenue procedure will be treated as a tax-free exchange under § 1035 if no amount, other than an amount received as an annuity for a period of 10 years or more or during one or more lives, is received under either the original contract or the new contract during the 180 days beginning on the date of the transfer (in the case of a new contract, the date the contract is placed in-force). A subsequent direct transfer of all or a portion of either contract involved in an exchange described in this section 4.01 is not taken into account for purposes of applying this section if the subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange under § 1035.

.02 A transfer that is within the scope of this revenue procedure but not described in section 4.01 will be characterized in a manner consistent with its substance, based on general tax principles and all the facts and circumstances.

.03 The Service will not require aggregation pursuant to the authority of § 72(e)(12), or otherwise, of an original, pre-existing contract with a second contract that is the subject of a tax-free exchange under § 1035 and section 4.01 of this revenue procedure, even if both contracts are issued by the same insurance company, but will instead treat the contracts as separate annuity contracts. See Rev. Rul. 2003-76; Rev. Rul. 2007-38, 2007-1 C.B. 1420.

#### SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for transfers described in section 3 of this revenue procedure that are completed on or after October 24, 2011. Rev. Proc. 2008-24 will continue to apply to transfers that are completed before that date, with the clarification of the requirement of section 4.01(b) that one of the prescribed conditions of § 72(q)(2) have "occurred between" the date of the transfer and the date of the withdrawal or surrender will be treated as satisfied if the condition was satisfied as of the date of the withdrawal or surrender. Thus, for example, an individual who attained the age of 59 ½ before both the date of the transfer and the date of the withdrawal or surrender has satisfied the condition of § 72(q)(2)(A) and will be treated as satisfying section 4.01(b) of Rev. Proc. 2008-24.

#### SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2008-24 is modified and superseded.

**DRAFTING INFORMATION**

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