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LEGAL ALERT

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IRS Modifies Guidance on Partial Exchanges of Annuity Contracts

On June 28, 2011, the Internal Revenue Service (IRS) issued Rev. Proc. 2011-38, which sets forth modified guidance with respect to the federal income tax treatment of "partial exchanges" of annuity contracts under sections 72 and 1035 of the Internal Revenue Code. In brief, Rev. Proc. 2011-38 provides that a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract will be treated as a tax-free exchange under section 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 existing annuity contract or the second annuity 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).

Under prior guidance – Rev. Proc. 2008-24, 2008-1 C.B. 684 – a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract was treated as a tax-free exchange under section 1035 if no amount was withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date of the transfer, or if the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 section 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 section 1035 instead was treated as a taxable distribution under section 72(e), followed by a payment for the second annuity contract.

Rev. Proc. 2008-24 was issued in the wake of *Conway v. Commissioner*, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi, which concluded that partial exchanges of annuity contracts can qualify for nonrecognition treatment under section 1035. The rules in Rev. Proc. 2008-24 were designed, in part, to limit taxpayers' ability to effect partial annuitizations, which, prior to this year, the IRS held did not qualify for exclusion ratio treatment under section 72(a), by effecting a tax-free partial exchange and then annuitizing either the existing annuity contract or the new annuity contract. Rev. Proc. 2008-24 also was intended to prevent taxpayers from effecting a partial exchange and then surrendering one of the annuity contracts soon thereafter, which could allow recovery of more investment in the contract on a tax-free basis than would be possible if the amount received on surrender had been withdrawn from the original annuity contract.

In Rev. Proc. 2011-38, the IRS accommodated the recent enactment of section 72(a)(2), which allows exclusion ratio treatment for partial annuitizations under certain circumstances, and addressed certain practical issues that had been raised in connection with its prior guidance by making the following changes to Rev. Proc. 2008-24:

- First, the 12-month period used in Rev. Proc. 2008-24 has been reduced to 180 days. Taxpayers had argued that the 12-month period used in Rev. Proc. 2008-24 caused administrative difficulties in certain situations where a federal income tax return already was filed for the year in which the transfer took place.

- Second, the rule requiring that one of the enumerated section 72(q)(2) conditions be met (or that a similar life event occur) has been eliminated. Taxpayers had commented that it was not clear

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how the "occurred between" standard described in Rev. Proc. 2008-24 should be applied with regard to those conditions (or similar life events).

- 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. Stated differently, Rev. Proc. 2011-38 does not apply to transactions to which new section 72(a)(2) applies.

- Fourth, the automatic characterization of a transfer as either a tax-free exchange under section 1035 or a distribution taxable under section 72(e), followed by a payment for a second annuity contract, has been eliminated. Taxpayers had commented that the alternative characterization of a transfer that does not qualify as a tax-free exchange was unclear.

Under the approach of Rev. Proc. 2011-38, the IRS will apply general tax principles to determine the substance, and hence the treatment, of a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract that does not meet the 180-day test described above. Thus, for example, an amount described by section 72(e)(1)(A) that is received under either the existing annuity contract or the second annuity contract within 180 days of the exchange may be characterized as either boot in a tax-free exchange or a distribution under section 72(e). However, a subsequent direct transfer of all or a portion of either contract involved in the exchange will not be taken into account for purposes of applying Rev. Proc. 2011-38 if the subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange under section 1035.

In keeping with the prior guidance, Rev. Proc. 2011-38 applies to the direct transfer of a portion of the cash surrender value of an existing annuity contract for a new annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies. The IRS specifically states in Rev. Proc. 2011-38 that it will not require aggregation pursuant to the authority of section 72(e)(12) (or otherwise) of an existing annuity contract with a second annuity contract that is the subject of a tax-free exchange under section 1035 and the revenue procedure, even if both contracts are issued by the same insurance company, but will instead treat the contracts as separate annuity contracts.

Rev. Proc. 2011-38 is effective for transfers 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 that the requirement set forth in section 4.01(b) of that revenue procedure that one of the prescribed conditions of section 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 59½ before both the date of the transfer and the date of the withdrawal or surrender has satisfied the condition of section 72(q)(2)(A) and will be treated as satisfying section 4.01(b) of Rev. Proc. 2008-24.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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