IRS DENIES IRC SECTION 1035 TAX DEFERRAL IN ANNUITY EXCHANGE

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Andrew M. Nerney and Andrew Brett Seiken, associates in Cummings & Lockwood's Private Clients Group, published an article entitled "IRS Denies IRC Section 1035 Tax Deferral in Annuity Exchange" which appeared on *Trusts & Estates* magazine website on June 29, 2016.

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IRS DENIES IRC SECTION 1035 TAX DEFERRAL IN ANNUITY EXCHANGE

Taxpayer's receipt of outright cash from original insurance company barred non-recognition

A taxpayer inherited an interest in an annuity from his late father. The taxpayer wished to exchange his interest in the inherited annuity for an annuity sold by a different insurance company. With the intent of qualifying the transaction as a permissible tax-free exchange, he mistakenly requested a "Lump Sum Payment" from the original annuity. After using a portion of the cash received to acquire a new annuity, the taxpayer requested a Private Letter Ruling to clarify that the transaction would still qualify as a tax-free exchange under Internal Revenue Code Section 1035(a)(2). The Internal Revenue Service, in PLR 201625001 (released June 17 2016), denied the taxpayer's request for non-recognition of income based on these facts.

Income Is Realized When an Non-Qualified Annuity Is Redeemed

IRC Section 72(a) provides that, except as otherwise provided in Chapter 1, gross income includes any amount received as an annuity under an annuity contract. When amounts are received under an annuity contract, but not as an annuity, such amounts are generally included in income under Section 72(e) to the extent allocable to income on the contract. Section 72(e)(5)(e) makes it clear that this rule applies to any amounts received on the complete surrender, redemption or maturity of an annuity contract. Whereas an individual redeeming a qualified annuity may be able to take advantage of rollover treatment under IRC Section 403(a)(4), thus avoiding inclusion of any part of the distribution in gross income of the annuitant, no similar rollover treatment exists for an individual redeeming a non-qualified annuity.

Exception to Recognition Upon Redemption

One exception to recognizing income on the redemption of an annuity is by exchanging the annuity for another. IRC Section 1035(a)(3) provides that no gain or loss is recognized on the exchange of an annuity contract for another annuity contract, provided the contracts exchanged must relate to the same insured and the obligee or obligees under the contract received in the exchange must be the same as those under the original contract.[1] As reported in the legislative history,[2] non-recognition treatment was granted to taxpayers who have “merely exchanged an [annuity contract] for another better suited to their needs and who have not actually realized gain.” The IRS has previously accepted and applied this view, ruling that when a contract issued by one insurance company is assigned to a second insurance company in exchange for a second annuity contract, no gain or loss is recognized by the exchange,[3] even when the second insurance company deposits the cash surrender value into a pre-existing annuity contract owned by the same taxpayer.[4]

No Exception When Taxpayer Receives Lump-Sum Payment

In the present case, there was no actual exchange of annuity contracts. There was no assignment of the contract to the new insurance company. There was also no direct transfer from the original insurance company to the other. The IRS denied the special treatment to the taxpayer in this case because the taxpayer received the cash outright from the original insurance company. As neither Section 1035 nor the regulations thereunder make any special provision for the purchase of an annuity contract with amounts distributed to the policyholder under another contract, the taxpayer was required by the IRS to recognize the gain in the year the annuity was redeemed.

Advisors Must Be Vigilant

The taxpayer at the center of this PLR may have been completely innocent in conducting the transaction as he did. The ruling by the IRS, however, emphasizes that the structure of the transaction is pivotal in determining the tax implications to the taxpayer. While the net effect of all transactions discussed above are the same (that is, the taxpayer replaced one annuity contract for another), a taxpayer must realize income if he/she receives and holds from the first insurance company, even for a fleeting moment, the consideration used to purchase the second annuity contract. Financial professionals must take care to ensure their clients don’t fall into this trap as the resulting tax, and the IRS, may be unforgiving.

Endnotes

1. 26 CFR Section 1.1035-1.
2. H. Rep. 1337, 83d Cong., 2d Sess. 81 (1954).
3. Revenue Ruling 72-358, 1972-2 C.B. 473.
4. Rev. Rul. 2002-75, 2002-2 C.B. 812.