

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:FIP:4-PLR-112763-02

Date:

July 9, 2003

Taxpayer

Policyholder

N

Date A

Dear :

This letter responds to your request dated Date A, submitted on behalf of Taxpayer requesting a ruling that the exchange of a portion of a variable annuity contract (Annuity Contract 1) for a deferred annuity contract (Annuity Contract 2) qualifies for tax-free exchange treatment under § 1035 of the Internal Revenue Code. Taxpayer also seeks a ruling on the proper allocation of basis between the contracts.

FACTS

Taxpayer, a stock life insurance company, is a calendar year taxpayer taxable under § 801. Policyholder, a cash method calendar year taxpayer, is the sole owner and annuitant under Annuity Contract 1 issued by Taxpayer. Policyholder's basis in Annuity Contract 1 is N. Policyholder proposes to instruct Taxpayer in writing to withdraw or transfer one-third of the gross account value on the date of the transfer (before reduction by any applicable surrender charge) to purchase Annuity Contract 2, issued by an unaffiliated insurance company. Policyholder will be the sole owner and annuitant of Contract 2. Policyholder represents that he has no prearranged plan to

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circumvent section 72 by surrendering or annuitizing Annuity Contract 2 within 12 months after its date of issue.

LAW AND ANALYSIS

Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for an annuity contract.

In Conway v. Commissioner, 111 T.C. 350 (1998), acq., 1999-2 C.B. xvi (Conway), the Tax Court concluded that a partial exchange of an annuity contract qualifies as a nontaxable exchange under § 1035. In Conway, the petitioner purchased an annuity contract from Fortis Benefits Insurance Co. ("Fortis"). Two years later she requested that \$119,000 be withdrawn from the Fortis annuity and directly transferred to Equitable Life Insurance Co. ("Equitable") for the purchase of a new annuity contract from Equitable. Fortis debited petitioner's annuity contract, retained a surrender charge, and transferred the balance of the withdrawal directly to Equitable. The court noted that the legislative history under § 1035 states the provision was enacted to provide nonrecognition treatment for taxpayers who have merely exchanged one annuity contract for another better suited to their needs and who have not actually realized gain. Furthermore, the court found that the policyholder in Conway was in essentially the same position after the exchange as she was in before the exchange, and the same funds were still invested in annuity contracts except that, after the exchange, the policyholder owned two annuity contracts. The Tax Court noted that the funds were transferred directly into another annuity contract without petitioner having any personal use of them. Therefore, petitioner's direct exchange of a portion of her Fortis annuity contract for a new Equitable annuity contract qualified under § 1035 and that petitioner did not need to recognize gain by reason of the exchange.

In this case, Policyholder wishes to take an amount from Annuity Contract 1 with Taxpayer and use that amount to purchase new Annuity Contract 2 with an unrelated insurance company. Policyholder will have no personal use of the funds. Accordingly, the proposed transaction qualifies as a nontaxable § 1035 exchange under Conway.

Treas. Reg. § 1.1035-1 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. Under the proposed transaction Policyholder -- as both owner and annuitant -- will be the obligee under Contract 1 and Contract 2. Thus the requirements of § 1.1035-1 are satisfied.

Section 1035(d)(2) refers to § 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.

Treas. Reg. § 1.1031(d)-1 provides, in part, that in a § 1035 exchange the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. Here, Policyholder wishes to take an amount from Annuity Contract 1 with Taxpayer and use that amount to purchase new Annuity Contract 2 with an unrelated insurance company. Neither § 1031(d) nor § 1.1031(d)-1 articulates a rule for the allocation of basis in a transaction involving the partial exchange of annuity contracts under § 1035(a)(3).

The Court in Conway held that there was a § 1035 exchange of an annuity contract for an annuity contract. Factually in Conway the policyholder still owned her original policy after the exchange, reduced in value to reflect the monies transferred to the new contract. To explain these exchange logically, the original contract immediately before the exchange (Contract 1) was divided into two contracts: "Contract 1A" and "Contract 1B." In the § 1035 exchange Contract 1B was exchanged for Contract 2 (the new contract) and Contract 1A remained as a contract owned by policyholder after the transaction. Under § 1.1031(d)-1 the basis of Contract 2 (the new contract) is the same as the basis of Contract 1B with proper adjustments to the date of the exchange. Accordingly, the basis of the original contract needs to be allocated to its two parts immediately prior to the § 1035 exchange.

Section 61(a) provides that except as otherwise provided in subtitle A, gross income means all income from what ever source derived, including gains derived from dealings in property. Section 61(a)(3). Treas. Reg. § 1.61-6 states that gain realized on the sale or exchange of property is included in gross income, unless excluded by law. Treas. Reg. § 1.61-6(b)(7) provides that gains or losses realized on the exchange of insurance policies and annuity contracts under § 1035 are not recognized. Under § 1.61-6(a), when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the parts, and the gain realized or loss sustained on the part sold is the difference between the selling price and the basis allocated to such part. Treas. Reg. § 1.61-6(a), Ex. 1. Cf. § 1031(j)-1(c) (requiring a proportional allocation of basis using fair market values in an exchange of multiple properties).

In this case the cost or other basis of the entire property can be equitably apportioned among the several parts using the relative cash values of those parts immediately before the proposed § 1035 exchange. Rev. Rul. 2003-76, 2003-33 I.R.B.

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To illustrate such an approach or formula, assume Annuity Contract 1 has a cash value of \$100x immediately before the § 1035 exchange, and a basis of \$30x ("Z"). Policyholder withdraws or transfers \$40x (assuming no surrender charges) from Annuity Contract 1 to Annuity Contract 2. Immediately before the § 1035 exchange, the cash value of Annuity Contract 1A is \$60x ("Y") and Annuity Contract 1B is \$40x ("X"). (Note that the cash value of Annuity Contract 1 immediately before any proposed exchange, and thus the cash values of its parts, is determined without regard to any surrender charges for purposes of allocating basis. If the policyholder withdraws \$40x and a surrender charge of \$4x is imposed such that only \$36x was paid into a second

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contract, the cash value of that portion of the contract immediately before the withdrawal/transfer/exchange is still \$40x.)

The computation of Policyholder's basis in the two portions of Annuity Contract 1 is as follows:

Annuity Contract 1A

$$\text{Basis} = [Y / [X+Y]] \cdot Z$$

$$\text{Basis} = [\$60x / [\$40x+\$60x]] \cdot \$30x$$

$$\text{Basis} = [\$60x / [\$100x]] \cdot \$30x$$

$$\text{Basis} = 0.6 \cdot \$30x$$

$$\text{Basis} = \$18x$$

Annuity Contract 1B and Annuity Contract 2

$$\text{Basis} = [X / [X+Y]] \cdot Z$$

$$\text{Basis} = [\$40x / [\$40x+\$60x]] \cdot \$30x$$

$$\text{Basis} = [\$40x / [\$100x]] \cdot \$30x$$

$$\text{Basis} = 0.4 \cdot \$30x$$

$$\text{Basis} = \$12x$$

Under § 1035(d), Annuity Contract 2's basis is equal to the basis in the annuity contract exchanged. Thus, Annuity Contract 2's basis is \$12x, the same as the basis of Annuity Contract 1B at the time of the exchange.

HOLDINGS

Accordingly, based on the information submitted and representations made, it is held:

1. The partial exchange by Policyholder of Annuity Contract 1 for Annuity Contract 2 issued by an unrelated insurance company will qualify as a tax-free exchange under § 1035, and no gain or loss shall be recognized on the exchange.
2. The basis of Annuity Contract 1 and Annuity Contract 2 will be determined under the formula set forth above by equitably apportioning the original basis of Contract 1 using the relative cash values of the parts of Contract 1 immediately prior to the exchange.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. As this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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This ruling is based on Policyholder's representation that he has no prearranged plan to circumvent § 72 by surrendering or annuitizing Annuity Contract 2 in the 12 month period immediately following the exchange. Notice 2003-51, 2003-33 I.R.B. ___, states that Treasury and the Service are considering whether an exchange of a portion of an annuity contract followed by a surrender of, or distributions from, either the surviving annuity contract or the new annuity contract that occur within 24 months after the exchange should be presumed to be entered into for tax avoidance purposes. Therefore, surrender or withdrawal of all or part of either Policyholder's Annuity Contract 2 or Annuity Contract 1 within 24 months of the date that Annuity Contract 2 is acquired might materially change the facts involved and may void this ruling, unless Policyholder can reasonably justify and demonstrate that the surrender or withdrawal is unrelated to the allocation of basis between the parts of Annuity Contract 1 or falls within the ambit of the interim guidance provided by Notice 2003-51.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, this letter does not address the definition of the "cash surrender value under the contract" that is to be taken into account after a material change under § 7702(c)(3)(A)(ii). Further, this letter does not address any aggregation issues that would arise if Annuity Contract 2 was issued by Taxpayer, instead of an unrelated insurance company.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 12.04 of Rev. Proc. 2002-1, 2002-1 I.R.B. 150. However, when the criteria in section 12.05 of Rev. Proc. 2002-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely yours,

DONALD J. DREES, JR.
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)