



## PARTIAL 1035 EXCHANGES AND ANNUITIES

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#### The FSD Fixed Annuity Journal And Interest Rate Review

A monthly guide for insurance agents reviewing fixed annuity product quality and performance.

February 2000

### PARTIAL 1035 EXCHANGES

#### HUGE OPPORTUNITY

Until early in 1999 a 1035 exchange was considered an all or nothing situation. Basically, Code Section 1035 was interpreted as allowing only a full exchange of one annuity (or life policy) for another annuity. In November of 1999, the IRS "acquiesced" to the earlier tax court ruling. (See the full text from the IRS website on page 2)

FSD is in touch with all our carriers to determine which ones have "acquiesced". As of this writing we have 2 confirmed, and in fact, have submitted partial 1035 requests to them. We feel all the others will follow shortly. Of concern of the carriers is how to allocate the cost basis. The obvious answer is to do it pro-rata and the carriers appear to be leaning in this direction. The allocation issue comes into play when distributions occur. (For example if a \$200,000 annuity with a cost basis of \$100,000 is exchanged for 2 annuities (A & B) and the cost basis is put on annuity "A", funds could be withdrawn tax free (or on a FIFO basis). Current tax law requires LIFO accounting (except for pre 8/15/82).

#### OPPORTUNITIES<sup>55</sup>

- Clients who are getting below market rates but are still in surrender period -move 10% free withdrawal to higher yielding product (example: USG 7.25%).

- Fixed rate annuity owners who may want to allocate some funds to an indexed annuity.

- Annuities which don't compound interest - move the interest and it compounds!

It is hard to imagine any fixed annuity owner who would not benefit from this flexibility. It is truly a win-win situation. Your client gets a better yield - you earn a new commission. As a simple example, any annuity which is not renewed at a rate of at least 6.5 - 7.25% would benefit by exchanging any amount which can move without charge to one of FSD's higher yielding multiple year rate guarantee products.

### CONSECO ANNUITY GIVES YOU A CHOICE!

With two new products that allow you to switch from an indexed linked account to a fixed account annually.

#### "Right Choice"

**100% Participation**  
**3.75% Margin 1st Year**  
**Monthly average/No cap**  
**1% Premium bonus**  
**7% Commission**  
**8 Year surrender**

#### "Choice"

**100% Participation**  
**0% Margin 1st Year\***  
**Monthly Average/No cap**  
**3% premium bonus**  
**16% Commission\*\*\***  
**15 year surrender\*\***

Terminal illness waiver \*\*  
 Nursing care waiver \*\*  
 Accidental death benefit \*\*

\* 3.95 Margin Waived 1st Year

\*\* Age restrictions apply, not available in all states.

\*\*\*Includes a 1% commission bonus for a limited-time.

### WOW

**7.25% For 6 Years**

**A WORD OF CAUTION**

Since this information is new and still being studied we suggest that you contact FSD so we can get specific company acceptance of your partial exchange. Some carriers are not in any hurry to "acquiesce". Additionally, Section 1035 applies to non-qualified funds only. Qualified funds have always enjoyed the benefit of this flexibility (trustee to trustee transfers).

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**ACTION ON DECISION**

SUBJECT: Conway v. Commissioner 111 T.C. 350 (1998) T.C. Dkt. No. 22257-96

**Issue:**

Whether a taxpayer's partial surrender of an annuity contract and direct transfer of the resulting proceeds for the purchase of a new annuity qualifies as a nontaxable exchange under I.R.C. § 1035?

**Discussion:**

In 1992, Taxpayer purchased an annuity contract from Fortis Benefits Ins. Co. (Fortis) for the amount of \$195,643. In 1994, the taxable year at issue, petitioner requested that Fortis withdraw \$119,000 from the annuity contract and issue a check to Equitable Life Ins. Co. of Iowa (Equitable) for the purpose of purchasing a new annuity contract from Equitable. Fortis mailed the check directly to Equitable. The Tax Court concluded that the transaction was a nontaxable exchange pursuant to section 1035. Consequently, the 10-percent penalty under section 72(q), which generally applies to taxable distributions from an annuity, was not applicable to the transaction. Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity contract. See also Treas. Reg. § 1.1035-1(c). The legislative history underlying section 1035 reflects that section 1035 was fashioned to eliminate the taxation of 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, 83 rd Cong., 2d Sess. 81 (1954). In this regard, the Tax Court in reaching its conclusion in this case explained that "[Taxpayer's] funds ... remain invested in a similar annuity contract, and [Taxpayer] has not personally received use or benefit of these funds since they were originally invested in the Fortis annuity contract in 1992." We agree with the court that as long as all of the funds in the original contract, less any surrender fee, remain invested in annuity contracts after the transaction, and, as long as the proceeds at all times during the transaction remained invested in annuity contracts, the transaction was within the parameters of section 1035.

The Service will continue to challenge transactions in cases where taxpayers enter into a series of partial exchanges and annuitizations as part of a design to avoid application of the section 72(q) ten percent penalty, or any other limitation imposed by section 72. In such cases, the Service will rely upon all available legal remedies to treat the original and new annuity contracts as one contract. Since the instant case did not involve a design to avoid application of section 72, we acquiesce to the decision of the Court.

**THIS DOCUMENT IS NOT TO BE RELIED UPON OR OTHERWISE  
CITED AS PRECEDENT BY TAXPAYERS**

**Recommendation:** Acquiescence

**Reviewers:** ROBERT A. MARTIN Attorney

Approved: STUART L. BROWN Chief Counsel

By: JUDITH C. DUNN Associate Chief Counsel (Domestic)

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how the products are built and not just how they work. **Become an annuity expert! To sign up call or [Email US!](#)**

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