Annuity partial 1035 exchange rules

An overview of revenue procedure 2011-38

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In June 2011, the Internal Revenue Service (IRS) updated the rules governing annuity partial exchanges with Revenue Procedure 2011-38. Revenue Procedure 2011-38 replaces Revenue Procedure 2008-24, which was the IRS' previous rulemaking pronouncement on partial exchanges.

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Why Are Partial Exchanges Advantageous?

Done correctly, partial exchanges can create the potential for less income tax[1] to be paid on post-partial exchange annuity withdrawals than if the withdrawal came from the single original annuity. When an annuity contract is divided into two contracts, a withdrawal from one of the contracts can reach the cost basis[2] more rapidly than if the annuity contract had not been divided.

Notable New Rules of Rev. Proc. 2011-38

Change One – Effective Date (October 24, 2011)

The rules of Rev. Proc. 2011-38 became effective for partial exchanges completed on or after October 24, 2011. Partial exchanges that took place prior to October 24, 2011 are governed by the rules of Rev. Proc. 2008-24.

Change Two – Timeframe (180 days) and Penalty (Aggregation)

For partial exchanges that occur on or after October 24, 2011, withdrawals within 180 days of the exchange, from an annuity that was part of the exchange, will either be taxable (1) to the extent of the gains in all the contracts that were part of the exchange, so-called aggregation, or (2) treated as a distribution from the single contract.

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[1] Withdrawals from non-annuitized annuities come from gain first, then investment-in-the-contract. Annuity gain is subject to ordinary income tax treatment, not capital gain treatment.
[2] The code does not use the term cost basis in conjunction with annuity contracts. Instead, it uses the term investment-in-the-contract. However, in common practice, the term cost basis is applied to annuities as it is to other investments. In this paper, I use the term cost basis to mean investment-in-an-annuity contract to match this common practice and for ease of understanding.

Rev. Proc. 2011-38 does not specify methods to determine which tax treatment a withdrawal within 180 days will receive. Thus, annuity owners who have undertaken a partial exchange should likely refrain from taking withdrawals within 180 days of the partial exchange to avoid the higher taxation that would likely result from aggregation.

Change Three – Deferred Annuity to Immediate Annuity Partial Exchanges Permitted

Under Rev. Proc. 2011-38, partial exchanges from deferred annuities into immediate annuities are now permitted. Prior to the ruling, the IRS had not issued definitive guidance as to the ability to undertake deferred to immediate partial exchanges.

This new guidance specifies that if the first annuity payment is received within 180 days of the partial exchange, then the annuity payment will not be aggregated as long as the payment is life based[3] or is a term certain only payout of 10 years or longer.

Please note that the 10% tax penalty for premature distributions will apply to the gain portion of the immediate annuity payments received prior to age 59 ½, unless the payout method is based on the life or life expectancy of the owner. If the owner is over age 59 ½, the 10% tax penalty does not apply.

Change Four – Rev. Proc. 2008-24-specified Exceptions Eliminated on October 24, 2011

In Rev. Proc. 2008-24, the IRS listed numerous exceptions to the negative tax implications of that revenue procedure. These exceptions included divorce, job loss and certain § 72(q) conditions like the over age 59 ½ exception. For partial exchanges occurring on or after October 24, 2011, all the exceptions mentioned in Rev. Proc. 2008-24, including the over age 59 ½ exception, are eliminated and cannot be used to avoid aggregation.

Examples

Let's look at two examples of how the rules of Revenue Procedure 2011-38 work. A numerical comparison of the examples appears in Table 1 below.

Scenario One – Violating the 180 Day Waiting Period Rule of Rev. Proc. 2011-38

Sam undertook a partial exchange on November 1, 2011 from a deferred annuity to another deferred annuity. Prior to the exchange, Contract A had $100,000 of cash value, of which $50,000 was cost basis and $50,000 was gain. 50% of the value of contract A, or $50,000, was exchanged into Contract B. On December 1, 2011, Sam took a withdrawal of $30,000 from Contract A. Assume no growth has occurred during this month.

Because this withdrawal occurred within 180 days of the exchange, the entire amount of the withdrawal, $30,000, would be taxable. The entire $30,000 would be taxable because, on the date of the withdrawal, the total amount of gains in Contract A and Contract B was $50,000.

Scenario Two – Satisfying the 180 Day Waiting Period of Rev. Proc. 2011-38

In this scenario, we see the advantages of partial exchanges and subsequent withdrawals if the rules of Rev. Proc. 2011-38 are followed.

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[3] The description "life based" includes all forms of lifetime payouts—Single Life, Life with Period Certain, Life with Refund, as well as all forms of Joint and Survivor payouts.

Assume the facts are the same as in Scenario One, except Sam waits until May 15, 2012 to take the $30,000 withdrawal from Contract A. Further assume that no growth had occurred during this time.

When the partial exchange occurred on November 1, 2011, a pro-rata portion of gain and basis was exchanged from Contract A into Contract B. The ratio of gain to basis on November 1, 2011, was 50/50. Thus, after the exchange, Contract A had $25,000 of gain and $25,000 of basis; Contract B had $25,000 of gain and $25,000 of basis. Upon reaching 180 days from the date of the partial exchange, each of the contracts stands alone as to their own amount of gain and basis. Therefore, on May 15, 2012, when Sam takes a $30,000 withdrawal from Contract A, only $25,000 is taxable and $5,000 is return of cost basis.

The result of Scenario Two compares favorably to the result of Scenario One from a taxation perspective because in Scenario Two Sam has $5,000 less taxable income than in Scenario One. In Scenario One, Sam took the distribution ($30,000) within the 180-day aggregation period, so the entire amount was taxable because the total gain in Contracts A and B was $50,000.

In Scenario Two, because Sam took the withdrawal ($30,000) after 180 days from the date of the partial exchange, the taxable amount of gain was based solely on the amount of gain in Contract A ($25,000). The other $5,000 of the withdrawal was a return of cost basis.

TABLE 1. A Numerical Comparison of Scenario One and Scenario Two

	Scenario One Violates the 180-Day Waiting Period of Rev. Proc. 2011-38		Scenario Two Satisfies the 180-Day Waiting Period of Rev. Proc. 2011-38	
	Contract A	Contract B	Contract A	Contract B
Pre-exchange Cash Value	$100,000	$0	$100,000	$0
Pre-exchange Cost Basis	$50,000	$0	$50,000	$0
Pre-exchange Gain	$50,000	$0	$50,000	$0
Exchanged Amount (A to B)	$50,000		$50,000	
Date of Exchange	November 1, 2011		November 1, 2011	
Post-exchange Cash Value	$50,000		$50,000	$50,000
Post-exchange Cost Basis	$25,000		$25,000	$25,000
Post-exchange Gain	$25,000		$25,000	$25,000
Distribution Amount	$30,000	$0	$30,000	$0
Date of Distribution	December 1, 2011	N/A	May 15, 2012	N/A
Taxable Amount	$30,000	$0	$25,000	$0
Return of Basis	$0	$0	$5,000	$0

What Should Investment Professionals Do With This Ruling?

1) If clients have taken withdrawals from annuity contracts that were part of a partial exchange, coordinate with the client's tax advisor to determine if any penalties may or may not apply.

2) Where and when appropriate, explore the uses of partial exchanges into either new deferred or immediate annuities as a way to create retirement income. Highlight the benefit of partial exchanges (i.e., faster access to cost basis) to clients who may be looking for income from nonqualified annuities. Be sure to include the caveat that they willl need to (1) wait 180 days

before accessing the values from deferred annuities, or (2) follow the listed exceptions if exchanging into immediate annuities to avoid negative tax implications of aggregation.

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NFM-9735AO.4 (07/16)