

# GREAT MARKETING OPPORTUNITY!

## LIFE COMPANIES ACCEPT PARTIAL TRANSFERS OF NON-QUALIFIED ANNUITIES

The tax court in Conway vs. Commissioner, 111 TC No. 20, held that a partial exchange of any annuity to another annuity contract constitutes a valid 1035 exchange, thus, no recognition of income is required upon such a transfer. Henceforth, many companies would like to both accept partial transfers of annuities and allow for partial transfers from their annuities. However, keep in mind that each transferring company makes an independent decision whether an exchange constitutes a valid 1035 exchange.

Please allocate basis on a proportional basis, for example if 50% is transferred then allocate 50% of the basis.

For annuity quotes, more information, or a listing of our participating companies call:  
**ROHRER & ASSOCIATES at 1-800-686-4238**

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The following review is part of the efforts by Rohrer & Associates to provide the agents we work with complete and accurate information on important issues. It is important to note that we cannot and do not give tax or legal advice. We recommend you and your clients seek personal advice from your own counsel on these matters.

### History of the Decision to Allow for a Partial 1035 Exchange

#### Background

In December of 1998, the Tax Court held that where an annuity holder transfers only part of the funds in one annuity to a second newly-issued annuity the transaction falls within the boundaries of Section 1035. Thus, the annuity holder does not have any taxable income as a result of the exchange. The following includes a brief background on this decision, information about comments made by the IRS, and our understanding of the industry's position regarding partial 1035 exchanges as of the above date.

An annuity holder, Mrs. Dona Conway, purchased an annuity in 1992 for approximately \$195,000 and at the time of the exchange, had not yet started to receive benefit payments from the contract. Two years after she purchased the annuity, Mrs. Conway wrote and asked the issuing company to withdraw \$119,000 from the annuity and send the check directly to another insurance company. (As a side note, it was interesting that no Absolute Assignment form was completed or required). Once the funds reached the second insurance company they were to go directly into another annuity contract.

The first insurance company did as Mrs. Conway requested and, after retaining \$10,000 in surrender charges, sent a check for \$109,000 to the second company. As soon as the second company received this check, it placed the full amount in a newly-issued annuity contract for Mrs. Conway. Further, the court notes, on her application for the new annuity Mrs. Conway specified that the transaction should be treated as a Section 1035 tax-free exchange.

In 1994, the first insurer issued a Form 1099-R indicating that the transaction was taxable, and that \$30,535 of the \$119,000 withdrawn should have been included in the taxpayer's income. On July 30, 1997 the company mailed a letter to the taxpayer stating that the issuance of the Form 1099-R was in error, and that the transaction should have been processed as a nontaxable section 1035 exchange.

The taxpayer did not include any portion of the withdrawal as income on her 1994 federal income tax return. Upon audit of the taxpayer's return, the Internal Revenue Service ("IRS") concluded that the withdrawal from the first contract did not qualify as a section 1035 exchange. The IRS therefore determined that the taxpayer under-reported income by \$30,535 (the taxable amount of the distribution), and that the distribution was also subject to a 10% penalty of \$3,054 under section 72(q).

In the Tax Court, the taxpayer argued that the transaction qualified as a nontaxable exchange under section 1035 because the original company did not distribute the funds to her, but transferred the funds directly to the second carrier. The IRS argued that the transaction did not qualify under section 1035 because the entire contract was not replaced. The IRS contended that the pertinent portion of Code section 1035 states "no gain or loss shall be recognized on the exchange of... an annuity contract for an annuity contract. Note: As near as we can tell, the IRS never challenged that fact that the transfer was a written request and never involved an absolute assignment.

## **Opinion**

The Tax Court held that the transaction qualified as a nontaxable exchange under IRC section 1035. Tax Court Judge rejected the IRS' contention, noting that "neither section 1035 nor the regulations condition nonrecognition treatment upon the exchange of an **entire** annuity contract." The Court noted that the IRS cited no authority for its position, and additionally that such a requirement was not implicitly required under the tax law. The Court's opinion also observed that the section 1035 regulations granted nonrecognition treatment to exchanges of annuity contracts as long as the obligee under the two annuity contracts was the same and that "NO" other requirements are set forth in the applicable regulations.

Citing the legislative history of section 1035, the Court noted that section 1035 was enacted to provide nonrecognition of an exchange where a taxpayer "merely" exchanges a contract for another and actually realizes no net gain on the transaction. The Court found that, with the exception of the surrender charge, the taxpayer was in essentially the same financial position after the exchange as before, i.e., the taxpayer received no personal use or benefit of the funds.

Based on this reasoning, the Tax Court held that the exchange of a portion of the first annuity contract for the new annuity contract constituted a nontaxable exchange under section 1035, even though the original annuity remained in force at a diminished cash value. Therefore, the taxpayer did not have to include as income any amount of the withdrawal from the contract. Additionally, the taxpayer was not subject to the 10% penalty tax under section 72(q).

For almost a year, the IRS never openly said what position it would take with respect to this ruling. Even though a 90-day limit to appeal the ruling expired, it continued to state that it was concerned with the possibility for abuse, thus casting enough of a shadow over the decision that carriers warned against policyholders relying on the ruling. Instead, almost all companies announced they were not accepting or disbursing partial withdrawals until the matter was completely confirmed.

Finally, in November of 1999 the Internal Revenue Service made its position known in the Conway vs. Commissioner decision by issuing an **Action on Decision** stating its "acquiescence" in this case. By issuing an **Action on Decision**, stating its acquiescence, the Service has accepted the ruling of the Tax Court and confirmed that it will follow its holdings in cases with the **same controlling facts**.

As of this date every company we have talked to agrees that the IRS's acquiescence to the Tax Court ruling legitimizes, using the "same controlling facts," the ability to transfer a portion of a non-qualified annuity and have the benefit of a tax-free exchange under Section 1035 of the IRC. However, we have found only a few companies who have been establishing procedures, amending their forms, addressing systems problems, etc., and are preparing to process policy owner requests.

We do expect that once a few carriers begin processing partial 1035's (this could be soon) others will necessarily follow quickly. You may always contact our office for the latest update on companies we represent.

### **IRS Warning**

Even though the IRS has decided not to challenge this particular ruling it has indicated that they are aware of the opportunity for abuse and that they will not countenance transactions that are designed to circumvent certain existing tax laws. Among those specifically cited were situations where taxpayers would enter into a series of partial exchanges and annuitizations as part of a design to avoid application of the Sec 72(q) 10% penalty or any other limitations imposed by section 72.

As a result, one of the most significant problems now facing insurance companies is to determine what is permissible and what could be considered abusive. They are also concerned with how to prevent (or warn) against possible problems, how to police transactions, and, if they occur, how problems should be reported.

No agent or company wants to be involved in a transaction that may be challenged and result in an adverse tax consequence. Since the Conway decision only sanctions a tax-free

exchange where the transaction is made using the same controlling facts, there is no assurance other transactions will not be challenged. So, we recommend you proceed cautiously, within the specific guidelines and accept the fact that it will take time to define acceptable transactions and procedures.

### **Potential Sales Opportunities**

Soon, we hope partial transfers will be an everyday part of servicing your clients' needs.

Whether you are using free withdrawal amounts or if appropriate, account values subject to a surrender fee, here are a few examples where a partial 1035 can provide deserving policy owners with important advantages.

Diversify retirement savings into different types of policies with different crediting provisions, i.e. bonus plans, long-term guarantees, equity index plans, etc.

Take advantage of rising interest rates.

Where appropriate, reduce exposure to amounts in excess of State Guarantee Fund limits.

Transfer cash values with low yielding renewal rates to competitive policies.

Improve flexibility by transferring to policies with more favorable policy features.

For liquidity, keep a portion of a policy, which is out of its surrender fee, then move the remainder to another plan that may have a higher yield or more favorable features.

This entire review is part of the effort by Rohrer & Associates to provide the agents we serve with timely and important information about issues concerning our business. It is important to note that we cannot and do not give tax or legal advice, that our information has been derived from a variety of sources and this review is a summary of our interpretation and understanding of the current status of this issue. Future interpretations and final results may differ. We recommend you and your clients seek professional advice from your own tax advisor on these matters.

We will continue to provide you with industry updates regarding when and how partial 1035 exchanges can be submitted to the insurance companies. In the interim please do not hesitate to call us with any questions you might have.

You may contact us at **1-800-686-4238** or email us at [rohrerassoc@charter.net](mailto:rohrerassoc@charter.net)

<b>Status of Partial 1035 Procedures by Company</b>			Update - June 19, 2002
<b><u>Company</u></b>	Accepting Partials into Co	Processing Partials Leaving Co.	<b><u>Comments</u></b>
<b>American Equity</b>	Yes	No	Will accept funds with information from prior carrier. Will not send out funds until they feel there are more guidelines from the IRS.
<b>American General</b>	Yes	Yes	Use standard 1035 form. Indicate amount requested on the form, but <u>do not</u> write the word "Partial" on it.
<b>Allianz</b>	Yes	Yes	Use standard 1035 form - Indicate partial 1035 and the percentage or dollar amount to be transferred for request to transfer money in or out. Client must also sign an acknowledgement letter. Allianz will call other carrier to see if any other requirements are needed.
<b>Business Men's Assurance</b>	No	No	Expects to finalize their position and procedures shortly.
<b>AVIVA Life</b>	Yes	Yes	Use standard 1035 form - indicate partial 1035 and the percentage or dollar amount to be transferred for request to transfer money in or out, in section 3 under witness signature.
<b>F&amp;G Life</b>	Yes	No	Finalizing forms and procedures. Will have a disclaimer. Will accept transfers in to company. (New 1035 Form Required) No actual target date for processing transfers out.
<b>Fort Dearborn Life</b>	Yes	Yes	Use standard 1035 form - indicate partial 1035 and the percentage or dollar amount to be transferred for request to transfer money in or out.
<b>Jefferson Pilot</b>	Yes	No	They will accept funds if other company supplies all needed information. No other forms required.
<b>Lincoln Benefit</b>	Yes	No	Use standard Assignment forms and write percentage or dollar amount to be transferred.
<b>Reliance Standard</b>	Yes	Yes	Special Partial 1035 form is available.
<b>USG</b>	Yes	Yes	No Special Forms Required. Indicate amount to be transferred on 1035 form.