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Annuity 1035 Exchanges

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What is a Section 1035 exchange?

From time to time, you may consider exchanging (trading) your annuity for another annuity. Exchanging your annuity means that you replace your annuity with an annuity issued by the same company or a different one. You may want to exchange your annuity, for instance, if your present company becomes insolvent or if you can obtain a better interest rate on another annuity. The rules governing the taxation of annuity and life insurance contract exchanges are spelled out in Internal Revenue Code (IRC) Section 1035. In general, under IRC Section 1035, you can exchange one annuity for another without the immediate recognition of any gain or loss. However, to obtain this favorable tax treatment, the exchange must satisfy the requirements for a Section 1035 exchange.

Types of exchanges considered nontaxable exchanges under Section 1035

- An annuity contract for an annuity contract
- A life insurance policy for an annuity contract
- An endowment contract for an annuity contract
- A life insurance policy for a life insurance contract
- A life insurance policy for an endowment contract
- An endowment contract for an endowment contract (as long as the new contract will begin making regular payments at a date no later than payments would have begun under the old contract)
- After 2009, a life insurance, endowment, annuity, or qualified long-term care contract can be exchanged for a separate or different qualified long-term care contract

One exchange that is considered taxable is the exchange of an annuity for a life insurance contract. In this case, any gain in the annuity contract upon exchange is treated as ordinary income to the policyholder. Why? Because otherwise exchanging an annuity for a life insurance contract would allow the holder of an annuity contract to convert benefits that were tax deferred under the annuity contract into benefits that could be received tax free under the life insurance contract (assuming that the life insurance contract is held until the death of the insured).

Tip: Section 1035 does not apply to policies or annuities that cannot be assigned (such as government-owned policies or annuities) and does not apply to qualified retirement plans because they are governed by other rules.

Section 1035 exchange rules

Old annuity or policy can't be cashed in and a new annuity or policy purchased

Generally, to be considered a tax-free exchange rather than a taxable surrender, an annuity contract or life insurance policy cannot be cashed in and the proceeds then used to purchase a new annuity contract or life insurance policy. Rather, the old annuity or policy must be traded for the new annuity or policy, usually by assigning rights to the old annuity or policy to the company issuing the new annuity or policy.

The contract must be exchanged for other property of like kind

For an exchange to qualify as nontaxable, the exchange must involve like-kind property (i.e., property that is similar in nature or class and of equal value). If the insured individual or annuitant receives cash or a payment in kind of cash or property, then part of the exchange involves property that is not like-kind. This part of the exchange is taxable, and gain must be recognized to the extent of the "boot" (i.e., cash or in-kind payment received).

This rule applies to cases where a loan against the annuity or life insurance policy is outstanding as well. Usually, annuities have no outstanding loans at the time they are exchanged, but life insurance policies occasionally do. If a loan secured by the policy is outstanding when the policy is exchanged and the obligation of the policy holder to repay the loan is cancelled as a result of the exchange, then the policyholder is considered to have received a cash payment in kind, because at some point he or she has received the funds and did not repay them. This cash payment in kind may be taxable to the policyholder and will be reported on Form 1099.

The owner along with the insured individual or the annuitant must remain the same

The owner along with the insured individual or the annuitant under the new contract must be the same as under the old contract. Otherwise, the exchange may be taxable.

Example(s): Martha owned a life insurance policy on her own life. She wanted to exchange the policy for another policy on the life of her husband, George. Unfortunately, this exchange was considered taxable because it did not meet the Section 1035 requirement that the insured individual remain the same.

Example(s): In the case of an exchange of annuity contracts, Section 1035 applies only if both contracts are payable to the same person or persons.

The new contract may be issued by a different insurance company

Although the insured individual or annuitant must remain the same when contracts are exchanged, the insurance company issuing the contract may change.

The basis of the new annuity will usually be the same as the cost basis of the old annuity or policy

The basis of the new annuity or policy will usually be the same as the basis of the old annuity or policy if no other cash or property is received. To determine the new annuity or policy's basis, the basis of the old annuity or policy is added to any premiums paid after the exchange and excludable dividends received after the exchange are subtracted. This basis becomes important if the annuity or policy is later surrendered, because, if there is a higher basis for the new annuity or policy, the amount of taxable earnings recognized upon surrender of the annuity or policy may be reduced.

Partial exchanges

Once an area of uncertainty, the Tax Court case *Conway v. Commissioner* clarified that certain partial exchanges will qualify as a nontaxable exchange under Section 1035. Under the facts of the case, the taxpayer instructed the insurance company to withdraw a portion of the funds in an existing annuity and to transfer those funds (less surrender charges) directly to a second insurance company for the purchase of a new annuity contract. Because the transfer of funds was made directly from one insurance company to the second insurance company (i.e., the taxpayer did not personally receive any of the funds), and otherwise satisfied the requirements of a Section 1035 exchange, the Tax Court determined there was no gain to the taxpayer.

The Treasury and the IRS subsequently issued temporary guidance on partial exchanges, later making the guidance permanent with Revenue Procedure 2008-24. An exchange of a portion of an annuity contract into a new annuity contract is generally treated as a tax-free exchange under Section 1035 of the Code. The basis (under IRC Section 1031) and investment in the contract (under IRC Section 72) of the surviving contract immediately before the exchange is allocated ratably between the surviving contract and the newly issued contract.

Janney Montgomery Scott LLC Financial Advisors are available to discuss the suitability and risks involved with various products and strategies presented. We will be happy to provide a prospectus, when available, and other information upon request. Please note that the information provided includes reference to concepts that have legal, accounting and tax implications. It is not to be construed as legal, accounting or tax advice, and is provided as general information to you to assist in understanding the issues discussed. Neither Janney Montgomery Scott LLC nor its Financial Advisors (in their capacity as Financial Advisors) give tax, legal, or accounting advice. We would urge you to consult with your own attorney and/or accountant regarding the application of the information contained in this letter to the facts and circumstances of your particular situation.

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