# WRNewswire
## An AALU Washington Report

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**TOPIC: Taxpayer's Receipt of Outright Cash from Original Insurance Company Barred 1035 Treatment for Annuity Exchange**

**CITES:** PLR 201625001 (June 17 2016); Greene v. Commissioner, 85 T.C. 1024 (1985); Rev. Proc. 92-44; Rev. Proc. 2011-38.

**SUMMARY:** The taxpayer inherited a non-qualified annuity from his father and wished to exchange the annuity for a new annuity issued by another insurance company. He assumed the exchange would be tax-deferred under Code Section 1035, but he failed to exchange annuity contracts as required by Section 1035. Instead, he cashed in the inherited annuity contract, taking a lump sum from the original insurance company, and deposited the proceeds into his checking account. He then used the proceeds to purchase a new annuity.

Informed of his mistake by his accountant, the taxpayer requested a private letter ruling from the IRS requesting favorable (no taxable event) treatment on the transaction.

The IRS ruled the distribution was taxable in the year it was received to the extent determined under Code Section 72(e).

**RELEVANCE:** The result in this ruling should not be a surprise to life insurance professionals. Code Section 1035(a) allows the exchange of a life insurance contract for another—or a deferred annuity for another—generally without requiring recognition of gain upon the exchange. However, failure to understand and follow the technical requirements of Code Section 1035 can lead, as it did here, to an unanticipated adverse result. While lenient rulings involving partial exchanges of annuities have been accorded Section 1035 exchange treatment (See Rev. Proc. 2008-24 as amended by Rev. Proc. 2011-38), the Service has for the most part required certain formalities to be strictly followed to accomplish the appropriate tax deferral.

To qualify as a Section 1035 exchange, the IRS strictly requires an exchange of policies, not an exchange of cash from an old policy for a new policy. The IRS has repeatedly ruled that, when exchanging policies, if the policy owner receives any cash proceeds from the old policy, even temporarily, the deferral of income under Code Section 1035 will not apply to the exchange by reference to Sections 1031 (b) and (c).

The IRS has been somewhat more lenient in validating unusual Section 1035 processing when the exchange involved original policies issued by carriers which have come under financial duress or are subject to a rehabilitation, conservatorship, insolvency, or similar state proceedings at the time of the cash distribution. See, for example, Rev. Proc. 92-44. Also, in Greene v. Commissioner, the Tax Court upheld Section 1035 exchange treatment even though the owner surrendered one annuity contract, received a check, and then endorsed that check to another carrier for issuance of a new annuity contract. Although the IRS acquiesced in the Greene decision, its subsequent rulings indicate that its continued position is this: The policy owner cannot have any access to cash proceeds from an exchanged annuity in a tax-deferred exchange.

To help ensure tax-deferral treatment under Section 1035, policy exchanges should be accomplished within the insurance carrier (or carriers) without any issuance of any cash proceeds to the policy owner. The policy owner should sign an absolute assignment of ownership and an exchange agreement with the transferee insurer, transferring all rights in the old policy to the insurer that will issue the new policy.

Clients do not always understand the practical and tax implications of mishandling exchanges. While the Service has the specific discretion to grant relief with respect to IRA rollovers (Section 403(a)(4)), because the annuity contract was a non-qualified contract, no rollover provision applied to the amount received.

Life insurance professionals should view the facts and result here as an opportunity to educate their clients on the potential problem and encourage clients to rely on them and their legal counsel to handle policy exchanges. Working with competent professionals will help avoid unpleasant surprises.

This unfortunate result provides yet another lesson to professionals: Even though the taxpayer claimed and could probably prove he had received no financial benefit from the fact that he had received cash in the transaction and that the entire amount he received was quickly transferred to purchase the new annuity, that did not protect him from current income taxation on the exchange.

**FACTS:** The taxpayer had inherited an annuity from his father. The taxpayer wished to transfer this balance to another annuity, but mistakenly signed a form that authorized a lump sum payment from the annuity, believing it was a form to exchange the annuity. The lump sum was deposited in the taxpayer's checking account and he used those funds, along with some additional funds, to purchase a new annuity.

The taxpayer started work on preparing his tax return when his accountant noticed that a Form 1099-R had been issued showing a fully taxable distribution of the balance of the annuity account to the taxpayer. The taxpayer filed for an extension of time to file the tax return and submitted the letter ruling request.

**The taxpayer requested two rulings:**

> 1. That the erroneous distribution from the inherited annuity and the subsequent contribution of those distributed funds to the new annuity be treated as a tax deferred exchange under Section 1035(a)(3) of the Code and not result in the imposition of income tax under Section 72(e) of the Code; and
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> 2. That no further corrective transactions be required as between the inherited annuity and the new annuity since, although the distribution was made erroneously, the end result is exactly as it would have been had the error not occurred.

As a practical matter, the taxpayer was arguing that he had gained no benefit from the fact that the value of the old annuity had not been directly transferred to purchase the new annuity. The IRS ruled that the distribution to him resulted in taxable income under Section 72(e).

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