Internal Revenue Service

Number: **201330016**
Release Date: 7/26/2013
Index Number: 72.19-00, 1035.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B04
PLR-146365-12

Date:
April 16, 2013

Taxpayer =

Company 1 =

Company 2 =

Company 3 =

Contract 1 =

Contract 2 =

Contract 3 =

Contract 4 =

Contract 5 =

New Contract =

Election Form =

Distribution Form =

Dear :

This is in reply to your request for a letter ruling under the Internal Revenue Code addressing a transaction you (Taxpayer) propose to enter into regarding five annuity contracts on which you are the beneficiary of the death benefit.

FACTS

Taxpayer represents as follows:

Taxpayer's mother owned Contracts 1, 2, 3, and 4, which are fixed annuity contracts issued by Company 1, and Contract 5, a variable annuity contract issued by Company 2 (collectively "Original Contracts"). Taxpayer is the beneficiary of these Original Contracts. Each Contract provides that upon the death of the owner (i.e., Taxpayer's mother) before the annuity starting date, the death benefit will be paid to the beneficiary (i.e., Taxpayer). The Original Contracts provide payment options consistent with § 72(s). Each Contract specifies the method to determine the amount of its death benefit.

Taxpayer's mother died, and Taxpayer timely elected to receive the death benefit provided by each Contract over her life expectancy, consistent with § 72(s)(2)(B).

Taxpayer perceives that she might be able to increase the amount of this payout if she can replace this payout with a payout offered by Company 3. To take advantage of this opportunity, Taxpayer applied to Company 3 for New Contract and completed both the Election Form and the Distribution Form. The value of the amounts due Taxpayer from Company 1 and Company 2 under the Original Contracts will be remitted directly to Company 3. Company 3 will then credit these amounts to New Contract. Under New Contract Taxpayer will be granted the same rights available to an owner of New Contract, except that (1) she cannot transfer ownership of New Contract and (2) she cannot make any new purchase payments to New Contract other than the assignment of the amounts due her from Company 1 and Company 2 under the Original Contracts. New Contract is nominally a deferred variable annuity contract, but by Election Form and Distribution Form, Company 3 is bound to immediately commence making payments that will continue the payouts being made by Companies 1 and 2 but in an amount determined pursuant to New Contract.

REQUESTED RULING

Taxpayer requests a ruling that the direct transfer of the value of the Original Contracts to Company 3 to acquire New Contract is an exchange of annuity contracts within the scope of § 1035(a)(3).

LAW

To be treated as an annuity contract under the Internal Revenue Code, § 72(s)(1)(B) provides that, subject to certain exceptions in § 72(s)(5), a contract must provide that if

any holder of the contract dies before the annuity starting date, the entire interest in such contract will be distributed within five years after the death of the holder. Section 72(s)(2) provides that if any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary, such portion will be distributed over the life of such beneficiary (or over a period not extending beyond the life expectancy of the beneficiary), and such distributions begin not later than one year after the holder's death or such later date as the Secretary may prescribe, then for purposes of § 72(s)(1), the portion shall be treated as distributed on the day such distributions begin (i.e., within five years after the death of the holder). Section 72(s)(4) provides that the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

Section 72(s) was added to the Code by § 222(b) of the Deficit Reduction Act of 1984, P.L. No. 98-369, 98 Stat. 494, 774 (1984). The provision originated in the House of Representatives, which proposed a rule that

> [i]n the event that the owner of any annuity contract dies before the annuity starting date, an amount equal to the cash surrender value of such contract shall be treated as paid to the contractholder immediately before death. Thus, the income in the contract will be subject to income tax in the decedent['s] return for the year of death. To prevent a second taxation when amounts are actually distributed to the new owner, the amount deemed to be distributed under the contract, that is, the amount includible in gross income of the decedent, is treated as a premium paid for the contract.

H.R. Rep. No. 98-432 (Pt II) at 1451 (1984).

The Senate amendment provided that

> [i]f the owner of any annuity contract dies before the annuity starting date, the specific distribution rules would apply, depending on decedent's beneficiary with respect to the contract. For these purposes, "beneficiary" is the person who becomes the new owner of the annuity contract. First, if there is a nonspousal beneficiary, the income in the annuity contract generally will have to be distributed within five years after the death of the owner.

S. Prt. 98-169 (Vol. I) at 580 (1984).

The conference agreement

> follows generally the Senate amendment, but with some modifications to the rules for the treatment of annuity

> contracts in the event of the contractholder's death. These modified rules generally conform to those applicable to qualified pension plans and IRAs.
>
> To be an annuity contract, the contract must provide that, … [i]f the contractholder dies before the annuity starting date, generally, the entire interest must be distributed within 5 years after the date of the death of the contractholder, or must be annuitized for some period (including the life of a designated beneficiary) within 1 year after that date.

H. R. Rep. 98-861 at 1077 (1984). See also, S. Rep. 99-313 at 993 (1986) (In providing the context for certain technical corrections to § 72(s), the report notes that the § 72(s) beneficiary "is the person who becomes the new owner of the annuity contract and controls the use of the cash value of the contract.")

Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for an annuity contract. Section 1035(b)(2) defines an annuity contract for purposes of § 1035 to be a contract of endowment insurance (i.e., a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life) but which may be payable during the life of the annuitant only in installments. Section 1.1035-1 of the Income Tax Regulations provides that the exchange, without recognition of gain or loss, of an annuity contract for another annuity contract is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract.

The House Committee Report to the Internal Revenue Code of 1954 indicates that § 1035 was designed to eliminate the taxation of individuals "who merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H.R. Rep. No. 1337, 83rd Cong., 2nd Sess. 81 (1954).

Rev. Rul. 92-95, 1992-2 C.B. 43, cites Rev. Rul. 85-159, 1985-2 C.B. 29, in concluding that a replacement contract received in a tax free exchange of annuity contracts is not treated as an investment in a new contract. Instead, the replacement contract retains the attributes of the exchanged contract for purposes of determining when amounts are considered to have been invested in the replacement contract. The Ruling holds that for purposes of §§ 72(u)(4) and (q)(2)(I), the "date of purchase" of a contract received in a tax free exchange is the date of purchase of the annuity contract exchanged for the new annuity contract.

Rev. Rul. 2003-76, 2003-2 C.B. 355, holds that in a partial exchange of annuity contracts under § 1035(a)(3), the investment in the contract and basis is allocated ratably based on the percentage of the cash value retained and transferred to purchase the new contract.

Rev. Rul. 2005-30, 2005-1 C.B. 1015, holds that if the owner-annuitant of a deferred annuity contract dies before the annuity starting date, and the beneficiary receives a death benefit under the annuity contract, the amount received by the beneficiary in a lump sum in excess of the owner-annuitant's investment in the contract is includible in the beneficiary's gross income as income in respect of a decedent within the meaning of § 691. If the death benefit is instead received in the form of a series of periodic payments in accordance with § 72(s), the amounts received are likewise includible in the beneficiary's gross income (in an amount determined under § 72) as income in respect of a decedent within the meaning of § 691.

Rev. Rul. 2007-24, 2007-1 C.B. 1282, holds that if a taxpayer receives a check from a life insurance company under a non-qualified annuity contract, the endorsement of the check to a second company as consideration for a second annuity contract does not qualify as a tax-free exchange under § 1035(a)(3). In other words, the transmission of funds must be directly between the life insurance companies for the transaction to qualify as a tax-free exchange under § 1035.

ANALYSIS

The Original Contracts provided for the distribution of the owner's (i.e., Taxpayer's mother) entire interest over the life expectancy of the beneficiary as required by § 72(s); this distribution regime is a *sine qua non* of an annuity contract. Accordingly, in the hands of Taxpayer's mother, the Original Contracts were annuity contracts within the meaning of § 1035(b)(2).

Taxpayer became the owner of the Original Contracts upon her mother's death, subject to the performance of the Original Contracts' obligation to distribute her mother's entire interest consistent with § 72(s). This obligation was performed when Taxpayer timely elected to receive the entire interest in the Original Contracts over her life expectancy consistent with § 72(s)(2)(B).

New Contract is also an annuity contract. Like the "date of purchase" for purposes of §§ 72(u)(4) and (q)(2)(I), and the allocation of investment in the contract and basis as part of a partial exchange, compliance with § 72(s) is an essential attribute of the Original Contracts that is retained by New Contract. The combination of New Contract, Election Form and Distribution Form obligates Company 3 to pay Taxpayer the entire interest her mother had in the Original Contracts consistent with the distribution regime required of the Contracts by § 72(s)(2): namely, a continuation of the terms of Taxpayer's election to receive the interest over her life expectancy. Accordingly, the essential inherent attribute of the Original Contracts – their compliance with § 72(s) – is retained and Taxpayer will ultimately recognize the income on the Original Contracts.

The value of the Original Contracts will be transmitted directly to Company 3. Assuming Companies 1, 2, and 3 are insurance companies as contemplated by § 1035(b)(2), this transaction is an exchange of annuity contracts within the scope of § 1035(a)(3).

RULING

A direct transfer of the value of the Original Contracts to Company 3 to acquire New Contract is an exchange of annuity contracts within the scope of § 1035(a)(3).

CAVEATS

The ruling contained in this letter is based upon information and representations submitted by Taxpayer accompanied by a penalties of perjury statement. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as explicitly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. No opinion is implied whether the proposed transaction is permitted by the Contracts.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by adoption of temporary or final regulations to the extent the regulations are not inconsistent with any conclusion in the ruling. See § 11.04 Rev. Proc. 95-1, 1995-1 C.B. 9. However, when the criteria in § 11.05 of Rev. Proc. 95-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely,

JOHN E. GLOVER
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: