Part I

Section 1035.--Certain Exchanges of Insurance Policies.

26 CFR: 1.1035-1: Certain exchanges of insurance policies.
(Also § 72.)

Rev. Rul. 2007-24

ISSUE

If a Taxpayer receives a check from a life insurance company under a non-qualified annuity contract, does the endorsement of the check to a second company as consideration for a second annuity contract qualify as a tax-free exchange under § 1035(a)(3) of the Internal Revenue Code?

FACTS

A, an individual, owned a non-qualified annuity contract issued by IC1, a life insurance company. In 2007, A requested that IC1 issue directly to IC2, another life insurance company, a check as consideration for a new annuity contract to be issued by IC2. A intended the transaction to be treated as a tax-free exchange under § 1035. IC1 refused to do so and, instead, issued a check to A. A did not deposit the check, but instead endorsed it to IC2 as consideration for a new annuity contract.

LAW AND ANALYSIS

Section 72(a) provides that, except as otherwise provided in Chapter 1 of the Internal Revenue Code, gross income includes any amount received as an annuity under an annuity contract. Under § 72(e), amounts received under an annuity contract, but not as an annuity, generally are included in gross income to the extent allocable to income on the contract. That is, they are taxed on an income-first basis. Section 72(e)(5)(E) provides that this rule applies to any amounts received on the complete surrender, redemption, or maturity of an annuity contract.

Section 1035(a)(3) provides that no gain or loss is recognized on the exchange of an annuity contract for another annuity contract. The legislative history of § 1035 explains that § 1035 provides non-recognition treatment for taxpayers who have "merely exchanged an [annuity contract] for another better suited to their needs and who have not actually realized gain." H. Rep. 1337, 83d Cong., 2d Sess. 81 (1954). Under § 1.1035-1, the contracts exchanged must relate to the same insured, and the obligee or obligees under the contract received in the exchange must be the same as those under the original contract.

In Rev. Rul. 72-358, 1972-2 C.B. 473, a taxpayer who owned a life insurance contract issued by one insurance company assigned the contract, prior to its maturity, to a second insurance company in exchange for a variable annuity contract issued by the second company. The ruling concludes that, pursuant to § 1035, no gain or loss is recognized on the exchange. Similarly, Rev. Rul. 2002-75, 2002-2 C.B. 812, concludes that an individual’s assignment of an annuity contract issued by one insurance company to a second insurance company, which then deposits the cash surrender value of the assigned contract into a pre-existing annuity contract owned by the same taxpayer, qualifies as a tax-free exchange under § 1035.

In the present case, there was no actual exchange of annuity contracts; nor did A assign the IC1 contract to IC2; nor was there a direct transfer from IC1 to IC2 of the cash value of the old contract in exchange for the new contract. Instead, IC1 disbursed a check to A, which A, in turn, endorsed to IC2 as consideration for a new contract. Neither § 1035 nor the regulations make any special provision for the purchase of an annuity contract with amounts distributed to the policyholder under another contract. Because the annuity contract was a non-qualified contract, no rollover provision, such as § 403(a)(4), applied to the amount received from IC1. Accordingly, the amount that A received from IC1 under the first annuity contract is taxable in 2007 to the extent set forth in § 72(e).

HOLDING

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). Instead, the amount received is taxable to the extent set forth in § 72(e).

DRAFTING INFORMATION

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