IRS approves tax-free exchange of annuity contracts by post-death beneficiary

September 10, 2013

In brief

In PLR 201330016, the IRS concluded that the post-death beneficiary of five annuity contracts could exchange the value of those contracts tax-free pursuant to Section 1035(a)(3) for a new annuity contract offering higher payouts. The ruling represents the first time the IRS has considered the application of Section 1035 to a contract held by a post-death beneficiary who is currently receiving distributions required by Section 72(s).

In detail

The taxpayer was the beneficiary of five annuity contracts that were originally issued by two different companies to her mother. Upon her mother's death, the taxpayer timely elected to receive the interest in the original contracts over her life expectancy, pursuant to provisions in those contracts that satisfied the requirements of Section 72(s). Section 72(s) generally requires that in order for a contract to be treated as an annuity contract, it must provide for required distributions in the event the holder dies before the entire interest in the contract is distributed.

The taxpayer subsequently decided to exchange the value of the five original contracts for a single contract, issued by a third company, that would provide higher payouts than the five original contracts. Although in form the new contract was a deferred variable annuity contract, the taxpayer completed an election form and distribution form requiring the third company to begin making payments immediately. The taxpayer would thus continue receiving the payouts that were being made by the original contracts, but in an amount pursuant to the new contract.

Under Section 1035(a)(3), no gain or loss is recognized on the exchange of one annuity contract for another. The legislative history of Section 1035 indicates that Congress viewed tax-free treatment as appropriate for individuals "who merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." The IRS also cited a number of revenue rulings that address the exchange of annuity contracts.

In its analysis, the IRS cited the legislative history of Sections 72(s) and 1035, as well as a number of its own revenue rulings. In addition, the IRS focused on the fact that the new annuity contract continued the terms of the taxpayer's election to receive the entire interest in the original contracts over her life expectancy. The IRS stated that compliance with Section 72(s) is an 'essential inherent attribute' of the original annuity contracts that is retained by the new contract. Additionally, the IRS determined that the taxpayer would ultimately recognize the income on the original annuity contracts under the new contract. Therefore, the IRS concluded that the transaction would qualify as an exchange of annuity contracts under Section 1035(a)(3).

The takeaway

PLR 201330016 makes it clear that a post-death beneficiary of an annuity contract may exchange that contract for another on a tax-free basis under Section 1035. This ruling is important for insurance companies who issue annuity contracts and for policyholders who hold annuity contracts and may wish to exchange them for new contracts.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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