



IRS Further Liberalizes Annuity Partial Exchange Rules

In recognition of real life scenarios impacting many US taxpayers today, the Internal Revenue Service recently loosened the complex compliance rules surrounding tax-free partial 1035 annuity exchanges followed by withdrawals and surrenders.

The IRS recently issued Revenue Procedure 2011-38, which revises an older Revenue Procedure 2008-24. Under the 2008 ruling, the IRS originally determined that tax-free partial 1035 exchanges of annuity contracts would be allowed but only with specific follow-on rules with special time limits to apply. In specific, as of June 20, 2008, the rules required that if a withdrawal, partial surrender or full surrender request occurs against the new contract within 12 months of receiving incoming 1035 exchange money, and the request does not meet the definition of an allowed exception, then the previous partial 1035 exchange is retroactively disqualified. The disqualified partial 1035 exchange would be reclassified into a routine taxable withdrawal from the original contract with tax implications for normal earnings versus principal determination.

The allowed exceptions included:

- owner death
- owner disability
- owner divorce
- owner loss of employment or other 'similar event'

On or after October 24 2011, the new ruling has reduced the monitoring time period following partial 1035 exchanges from 12 months to 6 months. The new ruling also removes the requirement to meet one of the allowed exceptions.

The new ruling has been made in recognition that taxpayers were having increased difficulty complying with the 12-month timeframe when they are dying or disabled. Compliance with the 2008 rules and the 12-month monitoring period further complicated any disqualification event that now required the taxpayer to file an amended tax return.

Even though the monitoring timeframe has been reduced from 12 months to 6 months, if a withdrawal or surrender request is received on a non-qualified accumulation annuity under the new rules, the customer service representative processing the request (or the online web portal simulating the same process) should still advise the contract owner of the special retroactive tax treatment that can disqualify the original partial 1035 exchange. Further guidance might be provided that the disqualifying event may be fully reported to the IRS as a partial withdrawal. This tax treatment reporting against the original partial 1035 exchange event will occur in addition to the current request for withdrawal.

When so informed, it is expected that most annuity contract owners will cancel the request for a withdrawal or at least postpone it to meet the 6-month rule. If the owner still wants to proceed with the desired withdrawal or surrender that fails the 6-month monitoring period, then a 1099R must be first generated for the failed prior partial 1035 exchange event. This action will result in an adjustment in the contract cost basis to the extent of a taxable distribution. After this event is completed, the withdrawal or surrender event can be processed.

The 6-month monitoring rule applies not only to withdrawal or surrenders against the new contract but also applies to requests against the old contract. Refer to IRS Revenue Procedure 2011-38 for additional details.

Visit: HamiltonSmithassociates.com or contact:

Dan Smith, President

email: Dan.Smith@hamiltonsmithassociates.com