



HAMILTON SMITH  
A S S O C I A T E S

**Sample Business Requirement for Download**

Partial 1035 Accumulation Annuity Exchanges

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## **Amendment History**

None

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## Business Objective and Scope Statement

The purpose of this business requirement is to describe the necessary support for partial 1035 exchange of annuities.

The Internal Revenue Code (IRC) in the United States has long recognized that there is a need to exchange or trade assets of various types throughout an owner's lifetime using special tax preferences. Without special provisions present in the IRC, any trade of any asset would be a taxable commerce transaction. There are special provisions for different classes of assets. The section that applies to life and annuity contracts is IRC Section 1035.

Specific rules must be complied with when performing a 1035 exchange of a life or annuity contract. For decades, the general rules have been:

- Contracts exchanges must be life to life, annuity to annuity or life to annuity
- Contract exchanges may be within a carrier or between carriers
- More than one contract can be involved in the trade
- Money associated with a 1035 exchange must be passed from carrier to carrier, not through the constructive receipt of the contract owner or his agent representative
- All value from each sending contract must be totally liquidated and sent into the new life or annuity contract. There was no such thing as a partial 1035 exchange.

The last rule has been questioned in a number of private letter rulings. In the well-publicized case of *Conway v. Commissioner*, (111 T.C. 350 (1998), acq., 1999-2 C.B. xvi), the Tax Court did recognize that a partial exchange of an annuity contract from one carrier to another would be treated as a tax-free exchange under IRC 1035 (a), rather than longstanding treatment that used Section 72 which defines tax and penalty treatments for withdrawals and partial surrenders.

On July 8, 2003, the US Treasury and the IRS issued Revenue Ruling 2003-76. This ruling defines the issue of partial 1035 exchanges and what rules and calculations must be followed to accomplish a valid transaction.

This requirement assumes that the software systems already in use already support full 1035 exchanges for life and annuity contracts. It will define only the additional new requirements for partial 1035 exchanges and will expect to co-exist with the pre-existing full 1035 support.

## Requirements Narrative Detail

The primary issue associated with partial 1035 exchanges is the proper calculation of gain versus owner investment (i.e. cost basis or post-tax dollars) in the contract and how that gain is allocated as a result of just part of the contract being exchanged into another contract. Without regulatory guidance, there would be a number of possible manners to classify if exchange proceeds constitute gain or investment.

To illustrate, let's examine a full 1035 exchange before the allowance of partial 1035 exchanges. Assume that a non-qualified deferred annuity that has an accumulated value of \$205,000 and a cash surrender value of \$200,000 is being fully exchanged from Carrier X to Carrier Y through the 1035 exchange provision in the IRC. Along with the full surrender check for \$200,000, two pieces of data are also provided by the old carrier to the new carrier: investment in the contract (AKA adjusted cost basis) and gain. Assume in our example that the investment in the contract is \$120,000 and the gain is \$80,000. (Note: gain is calculated net of any surrender charge.)

How should the definition of investment in the contract and gain operate now given the ability to move only part -- but not all -- of the cash value?

The revenue ruling is specific in disallowing the contract owner being able to determine or manipulate what type of value -- investment or gain -- is being transferred in the partial exchange. The guidance provided by US Treasury with respect to cost basis definition is that the portion of the cash surrender value exchanged should be "reduced ratably", or proportionately, between the cost basis and the gain of the original contract.

Now we will apply this concept against our prior full 1035 exchange example above of a non-qualified deferred annuity with Carrier A that has an accumulated value of \$205,000, a cash surrender value of \$200,000, cost basis

of \$120,000 and gain of \$80,000 (calculated net of the surrender charge). Assume that the owner requests a transfer of \$110,000 through a partial 1035 exchange.

The calculation first requires that the proportion of total investment to net cash surrender value be determined; in this case the ratio is \$120,000/\$200,000, or 60%. If 60% of the full cash surrender value is investment, then the remaining 40% is gain.

Request for partial 1035 transfer of \$110,000 --

Original Contract A:

Total Surrender Cash Value before 1035 exchange:	\$200,000
Cost Basis before partial 1035 exchange (60% proportion)	\$120,000
Gain before partial 1035 exchange (40% proportion)	\$ 80,000
Partial 1035 Exchange Request Amount	\$110,000
Remaining Total Surrender Value after partial 1035 exchange	\$ 90,000
Remaining Cost Basis after partial 1035 exchange (60%)	\$ 54,000
Remaining Gain after partial 1035 exchange (40%)	\$ 36,000

New Contract B:

Total Value directly after partial 1035 exchange*	\$110,000
Cost Basis right after partial 1035 exchange (60%)*	\$ 66,000
Gain right after partial 1035 exchange (40%)*	\$ 44,000

\*Assume no other new money or other 1035 exchange money accompanies the setup of the new contract B.

By providing this proportional guidance to taxpayers and insurers, Treasury is still concerned that there is room for abuse. It has stated through Notice 2003-51 that it may (but has not yet) add additional provisions that would require the tracking of such partial 1035 exchanges if there were a surrender or distribution (withdrawal, loan, etc -- to be defined) from the new contract within 24 months of the partial 1035 exchange. The suggested possible treatment is that the two

contracts -- at Carrier A and Carrier B -- would be treated as one for purposes of tax reporting purposes. While this onerous treatment is not in place, and raises other questions about how to accomplish this data coordination, it should be considered in the design and construction of how data is housed and carried in the event there is a need to "look back" to do so in the future. Furthermore, Treasury has also anticipated that there would be the common exceptions to any look-back rule for reasons that clearly are not the result of owner intentional manipulation. I.e. disability, divorce or substantially equal periodic payments as defined in Section 72 (q).

## **Product Administration Setup**

The following product lines are expected to require high volume support resulting from this enhancement.

- Non-qualified fixed accumulation annuities, including fixed index annuities
- Non-qualified variable accumulation annuities

While any individual non-qualified life insurance contracts with cash value can also technically participate in 1035 partial exchanges, they are out of scope for this business requirement, but will need to also follow the proportional allocation of investment versus gain as described above.

It is expected that all non-qualified accumulation annuities will be open for this type of exchange treatment. There generally will be no need to control which plan offerings in specific can allow or disallow this action, unless specific products disallow partial surrender action for reasons of design or possible forfeiture of inherent benefits in the process (i.e. surrender all or none). The assumption will be that any accumulation annuity that is non-qualified can take advantage of partial 1035 exchange activity.

## Distribution Channel

New annuity applications coming in from the distribution channel must be earmarked in the source documents as a partial 1035 exchange. Basis and earnings (i.e. gain) figures of monies being transferred will be required as accompanying information, but this specific information may follow later than the new application and will be available only when transferred from the originating carrier. Any information that is provided as part of the application process should be considered an estimate at best, requiring later confirmation from the relinquishing insurer. Earmarking a new application as partial 1035 exchange can occur in the form of a transmittal, a memo or in details section on the specific annuity application. This information is not expected to be incorporated into filed policy forms other than to know that the application is a replacement which is already present on virtually all filed annuity applications.

Deposits coming into the new carrier that are partial 1035 exchange money should not be received via the distribution channel. If such money does accompany an application, it does not comply with the spirit of the regulation for direct transfer so it must be addressed as an exception and researched as to origin and handling. Any 1035 exchange money – full or partial -- is expected to be transferred from carrier to carrier and the owner cannot take constructive receipt of the proceeds in the exchange process.

As is the case with full 1035 contract exchanges, non-1035 new money may accompany the partial 1035 exchange new application. The new money is treated as non-exchange and all value will be counted as investment in the contract (i.e. towards basis or post-tax). The best manner to do this is to expect to provide a general deposit marking ability to record a type of money or reason code with all new deposits indicating normal new, 1035 exchange full and now 1035 exchange partial. This information must be retained with evidence of the deposit.



## **New Business and Underwriting**

This requirement assumes that the current new business application entry systems in use support 1035 full contract exchange. For this reason, some indicator that the new application is for 1035 exchange must be captured.

It is recommended that a distinct indicator value different for full 1035 and partial 1035 exchange be provided. The indicator value must be carried on the pending new business record and retained later when the contract is in force for years. This indicator will be of assistance when matching receipts of carrier-to-carrier monies later, potentially after contract issue.

During the new business pending process, provide the ability to change the values, if any, that accompany any partial 1035 exchange in (e.g. gain versus investment in contract, or cost basis value contribution fields) during the new business process. Expect that this new process will be characterized by missing, late or incorrect information, so the ability to revise the cost basis and gain values is important.

Some carriers require that all 1035 monies are received before a new contract is issued. Others will issue the contract and wait for the exchange monies to arrive later. For this reason, the indicator value and gain versus investment fields need to be maintainable during pending process and after contract issue as well, with appropriate level of security and an audit trail of any changes – dates, users and replaced amounts.

## **Issue Requirements**

There are no new regulatory issue requirements anticipated to result from the partial 1035 exchange concept. The insurer may have a statement or letter produced to accompany the contract indicating that the contract is the result of partial 1035 exchange action. If so, expect a new letter or from trigger to be required.

If an insurer holds off contract issue pending receipt of full 1035 money receipts, then their policy will probably be the same for partial 1035 exchanges.

## Billing

There are no anticipated implications on billing notices resulting from partial 1035 exchanges. Any 1035 monies are not billed for by the carrier.

## Received Payments/Deposits

Methods of recording of payments/deposits against pending or in force annuity contracts need to be revised to recognize partial 1035 exchange money.

Like full 1035 exchange money, it is expected that partial 1035 exchange money will be sent to the new carrier from the old carrier. It may be passed directly from the original carrier to the new carrier in form of a check or through an electronic medium such as DTCC (new ACORD replacement data and money standards under development). The money will be accompanied by the following information:

- Total value of the transfer amount
- Investment amount of the total
- Gain amount of the total

For example:

- Total value of check                      e.g. \$15,543.22
- Investment in the contract              e.g. \$12,200.00
- Gain in the contract                      e.g. 3,343.22

It is assumed that the supporting contract administration systems already support full 1035 exchange, and there is a running "cost basis", adjusted cost basis also known as an ACB, associated with each annuity contract. The ACB is intended to represent the post-tax investment in the contract. Different methods are possible to track this value, but a common method is to track all deposits into the contract and if any deposit has a portion that is pre tax or gain, an adjustment must be made to the running total cost basis formula.

This adjustment for pre-tax gain is required for 1035 exchange monies, whether partial or full, since gain is pre-tax deemed to have no basis. To illustrate, assume a 1035 exchange deposit of \$500 – consisting of \$350 of basis and \$150 of gain -- is made into an existing non-qualified annuity contract. Assume the contract has \$3,000 of regular non-exchange money already present and no withdrawals have ever occurred. Before the deposit, the cost basis or adjusted cost basis/ACB would show:

ACB	=	Total Deposits	Minus Gain in Deposits	Minus Withdrawals
\$3,000	=	\$3,000	- 0	- 0

After the deposit of \$500, the ACB would show:

\$3,350	=	\$3,500	-150	-0
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Explicit prorated percentages values of investment versus gain may or may not be provided by the old Carrier. It is not necessary to capture the percentage as monies are deposited into the new contract, only the fact that the exchange is a partial 1035 and that pre tax and post-tax dollars are recognized in the running ACB.

If estimated values for gain and investment values of the expected money to follow later were captured at the time of the pending application, these must be reviewed and revised to reflect the now-correct values that accompany the transferred exchange money.

There are no laws requiring the sending carrier to indicate to the new carrier that the value is partial versus full 1035 exchange. It is necessary for the sending carrier to know the distribution was a partial 1035 exchange. See Client Service – Financial section later in this document.

It should be anticipated in the design that more than one contract may be tapped to perform a partial 1035 against and to send separately into the receiving contract. Also, an inforce contract that has been in force for some time can take in 1035 exchange money years after contract issue, so the ability to support partial 1035 exchange should continue throughout the lifetime of the receiving contract and must anticipate that more than one receiving deposit may occur over time.

## **Client Service – Non Financial**

For 1035 exchanges going out from a carrier, a new letter extract is anticipated that will define the fact that a withdrawal or partial surrender is a partial 1035 exchange and will show information on the breakdown of investment versus gain. Expect the letter to be desired by the receiving carrier and the owner of the contract for proof of the proceeds values.

## **Client Service – Financial**

The two types of financial activities impacted by the concept of partial 1035 exchange are withdrawals and partial surrenders. Both leave the original contract in force and some but not all of the value is removed.

Expect to make revisions to either or both of these processes if they are distinct in order to capture the fact that any resulting distribution will need to know the action is a partial 1035 exchange. Further, when a withdrawal or surrender amount figure is entered, the system will now have to invoke the new prorated value calculation described previously to determine the portion of investment versus gain in the distribution. This breakdown will have to be provided to the new carrier or, if this is an internal replacement at the same carrier, to the new contract along with the check for partial 1035 exchange proceeds. Lastly the data must persist in the system to pass into the 1099R later. See Tax Reporting section later for more information on 1099R.

Repeating a previous example, assume that the current Carrier X has been advised by the contract owner that a partial 1035 exchange is desired to go to Company Y and the owner wants to remove \$110,000 from his Contract A. His Contract A has current cash value of \$200,000:

Original Contract A:

Total Cash Value before partial 1035 exchange:	\$200,000
Cost Basis before partial 1035 exchange (60%)	\$120,000
Gain before partial 1035 exchange (40%)	\$ 80,000
Partial 1035 Exchange Request Amount	\$110,000
New Remaining Total Cash Value after partial 1035 exchange	\$ 90,000
Remaining Cost Basis after partial 1035 exchange (60%)	\$ 54,000
Remaining Gain after partial 1035 exchange (40%)	\$ 36,000

Information to Accompany Partial 1035 Exchange Check:

Total Value directly after partial 1035 exchange	\$110,000
Cost Basis right after partial 1035 exchange (60%)**	\$ 66,000
Gain right after partial 1035 exchange (40%)**	\$ 44,000

\*\*percentages may or may not be provided. Figures have to be provided.

The request for a withdrawal or partial surrender that is partial 1035 exchange will need to initiate a new calculation of pro-rata as illustrated above. A letter extract to accompany the distribution must show the decomposition of the \$110,000 into \$66,000 cost basis and \$44,000 gain. The fact that the distribution was a partial 1035 exchange must be preserved as part of the audit trail of the action. This audit trail will be needed for future service evidence and for potential inquiries or later laws that may require some cross-company sharing (not a law yet, but a good design to preserve the information values and percentages).

We are assuming that full 1035 exchange processes are already supported in existing systems, and that each annuity contract has associated with it a running cost basis, sometimes called cost basis or adjusted cost basis (ACB) value that is maintained throughout the lifetime of the contract.

The updating of the running ACB may also be impacted due to partial 1035 exchange. Using our above example, the ACB must reflect that \$110,000 has exited the contract. A new pair of fields may be desirable to use in addition to current withdrawals fields and reflect separately from the actual ACB formula. For example, the following information must be retained:

Partial 1035 exchange, basis portion

Partial 1035 exchange, gain portion

A 1035 exchange is not a taxable event, but a reportable event. The investment in the contract must be reduced, however, for the basis dollars that have exited. So to continue our example above, before the request for partial 1035 exchange was received, Contract A has an ACB that looked like this (assume there were no prior withdrawals and no prior 1035 exchange monies in):

$$\begin{array}{rcccc} \text{ACB} & = & \text{Total Deposits} & \text{Minus Gain in Deposits} & \text{Minus Withdrawals} \\ \$120,000 & = & \$120,000 & - 0 & - 0 \end{array}$$

After the partial 1035 exchange withdrawal of \$110,000, of which \$66,000 was basis and \$44,000 was gain based on pro-ration, the ACB would show:

$$\begin{array}{rcccc} \text{ACB} & = & \text{Total Deposit} & \text{Minus Gain in Deposits} & \text{Minus withdrawals} \\ \$54,000 & = & \$120,000 & -0 & \$66,000 \end{array}$$

New fields: Partial 1035 exchange basis out: \$66,000

Partial 1035 exchange gain out: \$44,000

Assume that more than one partial 1035 exchange can occur out of a contract or into a contract, so retaining details and dates of each event is good design.

## Accounting

There are no unique accounting impacts for partial 1035 exchange. All entries will mirror the same accounting debits and credits that are used for full 1035 exchange entries.

## Claims

There are no impacts on death or disability claims resulting from partial 1035 exchange activity.

## Tax Reporting

The concept of 1035 exchanges applies to non-qualified life and annuity contracts only. Support for qualified contracts will not be required. (There are some industry practices that attempt 1035 exchanges within qualified contracts. They are out of scope from this requirement and we would refer to these as rollovers.)

There may be changes to the current handling of running cost basis AKA adjusted cost basis/ACB. Most formulas will assume that all 1035 exchanges are full today, not partial. Anticipate some changes to the values and processes "behind the scenes" to be able to continue to support the running formula and to also rely on partial exchange information as part of it. Refer to example in Client Service – Financial section above for potentially two new supporting fields to be housed near the running cost basis total.

### 1035 Exchanges In --

There are currently no formal impacts to 1099R reporting for money coming into a contract.

When a 1035 exchange is performed, more information will need to be recorded now in conjunction with each of the exchanges coming in. It is recommended that a full history of the detail that comprised each 1035 transfer -- both full and partial -- begin to be kept. This data will be required in the event there is a need to do any backward investigation of money origin, source and the

breakdown of cost basis and gain from each carrier in the future. Remember that on any 1035 exchange coming in, the values are set by the other carrier or contract, not by the new contract, so this is a passive recording of data.

#### 1035 Exchanges Out –

Internal Revenue Service form 1099R extracts must capture any distribution from an annuity contract and indicate what portion is taxable. For a full 1035 exchange, already assumed to be supported in system in place, the 1099R Box 7 must show a value = 6. The investment in the contract figure should be shown in Box 5. These same rules must be used for partial 1035 exchange. There is currently no special code handling for partial 1035 versus full 1035.

The same breakdown of detail of exiting 1035 monies, the designation of those monies into cost basis or gain and the proportional percentages that were calculated and used, as part of the exit, will be required. This information all will be stored as a result of an active calculation that will need to be triggered through a new withdrawal/partial surrender request transaction (defined previously under Client Services – Financial). This data will be needed to answer questions from owner, agent, other carrier etc so it needs to be complete.

## **Additional Considerations**

None.

## **Future Considerations**

Expect that US Treasury is not finished with tweaking this requirement and backtracking into old partial exchanges among carriers may become necessary. If in doubt, save the data in the data base so it can be readily accessed.

## **Appendices**

None.