

Not All Partial Transfers of NQ Annuities Are Treated The Same

By DANNY FISHER

LIFE IS MUCH SIMPLER FOR CAREER agents and policy owners who only do business with one insurer because they only have to learn one company's rules and how that company interprets Internal Revenue Service rules. Life is much more difficult for independent agents and policy owner's who do business with several insurers because they have to learn each company's rules plus how each company interprets IRS rules.

annuity contracts occurs, the cost basis and gain in the contract should be proportionally allocated between the two contracts.

➤ In **Notice 2003-51**, the IRS announced it is considering issuing regulations providing that if a taxpayer effects a partial exchange of one annuity contract and then surrenders or takes a distribution from one of the resulting contracts within 24 months after the exchange, the exchange will be treated

it will transfer funds proportionately. If the owner surrenders Annuity B or takes a distribution within 2 years of the transfer, the values would be aggregated and adjusted, as shown in the chart. This process is virtually impossible to enforce; therefore, the company will send a 1099-R to the owner noting the taxable amount as "undetermined" rather than trying to contact the other company to aggregate the values. If the remaining contract is transferred, surrendered, or a distribution occurs after two years, the proper amounts will be shown on the 1099-R.

Another company follows Rev. Rul. 2003-76 but takes an extremely conservative position on Notice 2003-51 by requiring the policyowner to verify that he/she understands the company will prepare all future 1099-Rs with a taxable amount as "undetermined."

The remaining company gave the most "off the wall" answer of all. It will treat the partial exchanges as a tax-free transfer, but the amounts will be based on a Last In First Out basis. I assumed my questions were unclear, so I

sent them again asking the company to consider *Conway v. Commissioner*. The corporate attorney called and curtly declined to answer any more questions. My translation, "The company has no idea what it is doing."

Some other points of interest: While one company will allow the transfer, a sister company, owned by the same parent company, may not allow the transfer. Some will allow the transfer on fixed annuities, but not on variable annuities. Some allow a partial transfer from one annuity into an existing flex-pay annuity, while other companies will only allow a partial transfer into a new contract.

One executive took the discussion to a higher plain. After noting that his firm has to process each partial transfer manually (because its computer systems pre-date the IRS ruling), he said: "It's a pain in the neck, but we feel we have a moral and fiduciary responsibility to obey the law and meet the desires of our customers."

Life would be simpler if all insurance companies adopted the same attitude, but that's just a pipe dream of mine. **NU**

THE RULES

PARTIAL TAX-FREE EXCHANGE CHART

Annuity	Now A	Rev. Rul. 2003-76 Transfer Ratios		In the Future			Notice 2003-51 Results	
		A	B	A	B	A + B	B	A
	Values Before Transfer	20% Remaining Values	80% Partial Transfer	Values	Values	Values	Aggregate Surrender Values	Remaining Values
Cost Basis	60,000	12,000	48,000	12,000	48,000	60,000	38,000	22,000
Taxable Gain	40,000	8,000	32,000	10,000	40,000	50,000	50,000	0.00
Total Value	\$ 100,000	\$ 20,000	\$ 80,000	\$ 22,000	\$ 88,000	\$ 110,000	\$ 88,000	\$ 22,000

Source: Danny Fisher, Fisher Annuity Index, Dallas

Anyone who thinks IRS rules are applied the same with all companies is dreaming. Insurers often have their own "rules to the game," which may or may not agree with other companies.

For example, I recently contacted 71 insurers with some simple questions about how they treat partial tax-free transfers of nonqualified annuities to other companies after the IRS acquiesced in *Conway v. Commissioner*, 111 T.C. 350 (1998). A very brief summary of that court case follows:

The Tax Court held that partial exchanges of annuity contracts could qualify for non-recognition treatment under section 1035(a) of the Internal Revenue Code. The IRS has provided guidance on partial exchanges of annuity contracts in two documents:

➤ In **Rev. Rul. 2003-76**, the IRS has taken the position that when a partial exchange of one annuity contract for two

as a single integrated transaction.

(For more information on *Conway v. Commissioner*, go to www.irs.gov and search for Rev. Rul. 2003-76 and Notice 2003-51.)

Of the 71 companies contacted, 19 never responded. One called to say it would not answer any questions unless they pertained to a specific policy with the company.

Of the 51 responding companies, 21 said they do not allow partial transfers of nonqualified annuities. A common response was their computer systems were not programmed to handle such transfers.

The remaining 30 allow partial transfers, but with different interpretations of how to apply the rules.

Currently, 27 of the 30 companies will follow Rev. Rul. 2003-76 and disregard Notice 2003-51 until such time as the IRS actually imposes the regulation. As shown in the Chart, if 80% of an annuity is transferred, the cost basis and gain will be divided proportionally between the two annuities.

One company will follow Rev. Rul. 2003-76 and Notice 2003-51. Basically,

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