

## Section 1035.—Certain Exchanges of Insurance Policies

26 CFR 1.1035-1: Certain exchanges of insurance policies.

(Also Part I, §§ 72, 1031)

**Tax-free exchange of annuity contracts.** This ruling states that the transfer of an entire annuity contract into another pre-existing annuity contract qualifies as a tax-free exchange and defines the basis and investment in the contract for the surviving contract.

### Rev. Rul. 2002-75

#### ISSUES

Is the taxpayer's assignment of an entire annuity contract to a second insurance company, which then deposits the cash surrender value of the assigned annuity contract into a pre-existing annuity contract owned by the same taxpayer, and issued by the second insurance company, a tax-free exchange under § 1035? What is the basis under § 1035 and the investment in the surviving contract under § 72 after the transfer?

#### FACTS

A owns Contract B, an annuity contract issued by Company B, and Contract C, an annuity contract issued by Company C. A is the obligee for both contracts. A seeks to consolidate Contract B and Contract C. A assigns Contract B to Company C. Company B transfers the entire cash surrender value of Contract B directly to Company C. Company C includes the transferred cash surrender value of Contract B in Contract C. A will not receive any of the cash surrender value of Contract B that is transferred to Company C and deposited into Contract C. No other consideration will be paid by A in this transaction. The terms of Contract C are unchanged by this transaction, and Contract B terminates.

#### LAW AND ANALYSIS

Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for an annuity contract. Section 1.1035-1 of the Income Tax Regulations provides that the exchange,

without recognition of gain or loss, of an annuity contract for another annuity contract under § 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in the exchange as under the original contract.

The legislative history of § 1035 states that exchange treatment is appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).

Section 1035(d)(2) cross-references § 1031 for the rules to determine the basis of property acquired in a § 1035 exchange. Section 1031(d) provides that property acquired in a § 1035 exchange has the same basis as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by any gain (or decreased by any loss) recognized by the taxpayer on the exchange.

Section 1.1031(d)-1 provides, in part, that in a § 1035 exchange the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

Section 72 governs the federal tax treatment of distributions from an annuity contract. For purposes of determining income, gain, or loss from an annuity contract, § 72 contains two special definitions of investment in the contract. When amounts received are not annuity payments, § 72(e)(6) defines the investment in the contract. For purposes of § 72(b), which applies to annuity payments, § 72(c)(1) defines the investment in the contract in a similar, but not identical, manner.

After completion of the transaction, A owns only Contract C, which has been increased in value to reflect the cash surrender value transferred into it from Contract B. A had no access to the cash surrender value transferred in the exchange. Therefore, this transaction is treated as an exchange that is tax-free under § 1035.

As a result of the application of § 1035(d), A's basis in Contract B is included in A's basis in Contract C immediately after the exchange, and under § 72(c)(1) and § 72(e)(6), A's investment

in Contract B is included in A's investment in Contract C immediately after the exchange.

#### HOLDINGS

(1) The assignment by A of Contract B to Company C for consolidation with pre-existing Contract C is a tax-free exchange under § 1035.

(2) After the assignment, pursuant to § 1035, A's basis in Contract C immediately after the exchange equals the sum of A's basis in Contract B and A's basis in Contract C immediately prior to the exchange.

(3) After the assignment, A's investment in Contract C under § 72 equals the sum of A's investment in Contract B and A's investment in Contract C immediately prior to the exchange.

#### DRAFTING INFORMATION

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