EXECUTIVE SUMMARY:

In PLR 201038012, the IRS expands the framework for allowing partial 1035 exchanges of annuities with subsequent withdrawals... and perhaps unwittingly partially opens back up the loophole that they have been long fighting to close.

FACTS:

Taxpayer owned an annuity contract, and was over the age of 59 1/2.

Taxpayer requested a partial 1035 exchange of the annuity from one annuity company to another.

Consistent with an ongoing practice of taking annual withdrawals from various accounts for gifting purposes, taxpayer requested a withdrawal from the new annuity contract, within 1 year of the partial 1035 exchange.

Because of the withdrawal from the new partial exchange annuity within 1 year of the exchange event, taxpayer was informed that the annuity company would report the partial 1035 exchange amount as a taxable distribution, pursuant to the rules of Revenue Procedure 2008-24.

COMMENTS:

*Technical Background*

Revenue Procedure 2008-24 was the capstone of a long series of guidance issued by IRS and Treasury in response to perceived abuses from partial 1035 exchanges, going back to the case of Conway v. Commissioner (1998), and superseding IRS Notice 2003-51.

The original "tax avoidance scheme" the IRS was seeking to address typically occurred as follows:

John Smith holds a $100,000 annuity with a $60,000 cost basis. He wishes to withdraw $40,000 from the annuity (which would normally be fully taxable as a gains-first withdrawal under IRC Section 72(e)). Instead, he completes a $40,000 partial exchange to a new annuity #2, which receives a 40% pro-rata allocation of basis ($24,000) associated with the $40,000 transfer. Subsequently, John liquidates the new $40,000 annuity #2, resulting in a reported gain of $16,000 on proceeds of $40,000, instead of a full $40,000 gain. Thus, John can extract a portion of his cost basis, and defer a portion of his gains, by completing a partial exchange followed by a withdrawal, in lieu of taking a withdrawal from the original contract.

In Conway v. Commissioner, the Service first sought to deny partial 1035 exchanges, in an attempt to prevent the tax avoidance strategy; however, the Service lost and acquiesced. It followed a few years later with IRS Notice 2003-51, allowing partial 1035 exchanges, but noting that a withdrawal within 24 months of the exchange will be presumed to have been done for tax avoidance reasons. This presumption could be rebutted by holding the new annuity beyond the proscribed 24-month period, or by demonstrating that the subsequent surrender or withdrawal was not contemplated at the time of the partial exchange (either by outright facts and circumstances, or possibly other notable events such as divorce, loss of employment, etc., as set forth in Treas. Reg. 1.121-3T(e) with respect to the personal residence capital gains exclusion), and/or if the distribution would otherwise not have been subject to the 10 percent early withdrawal penalty tax (effectively as a safe harbor for demonstrating such a rebuttal). If the partial exchange was deemed a tax avoidance scheme under IRS Notice 2003-51, the subsequent withdrawal from the new annuity would be treated as though it had occurred with both the original and new annuity combined into a single contract (reverting the tax consequences back to what they would have been if the withdrawal occurred directly in the first place).

The guidance from IRS Notice 2003-51 was updated and superseded by Rev. Proc 2008-24, which applied a few notable changes to the prior guidance. First, the 24-month safe harbor time period was shortened to 12 months. Second, the "not contemplated at the time of exchange" clause was removed (likely due to the difficulty of overseeing it effectively). Third, the guidance stipulated directly that the partial exchange would still apply if any of the conditions under IRC Section 72(q)(2) (exceptions to the 10-percent early withdrawal penalty) applied between the date of the transfer and the date of the withdrawal/surrender of the new annuity. Under Rev. Proc. 2008-24, if the partial exchange guidelines were not followed, the result was not just a recharacterization of the tax consequences of the withdrawal as though the two contracts were one; instead the guidance provided that failure would cause the entire partial 1035 exchange itself to be treated as an invalid 1035 exchange (and thus retroactively taxable).

*Interpreting Rev. Proc. 2008-24*

Under Rev. Proc. 2008-24, there were two specific guidelines provided to avoid the scope of a failed partial 1035 exchange, under Section 4.01(a) and (b):

.01. A transfer that is within the scope of this revenue procedure will be treated as a tax-free exchange under § 1035 if either—

(a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); or

(b) the taxpayer demonstrates that one of the conditions described by § 72(q)(2)(A), (B), (C), (E), (F), (G), (H) or (J), or any similar life event (such as divorce or loss of employment), occurred between (i) the date of the transfer, and (ii) the date of the withdrawal or surrender.

The first clause was relatively straightforward. The second clause, however, was a bit less certain, but appeared to be similarly straightforward - if one of the conditions occurred, such as a death, divorce, or similar life event, after the exchange but before the withdrawal (i.e., precipitating the withdrawal), that the taxpayer's partial 1035 exchange would be allowable even if the 12-month time period had not passed.

*The need for the PLR*

Thus, in the taxpayer's scenario in PLR 201038012, it appeared that the taxpayer had a problem. The one-year time period had not occurred, and there was no direct occurrence of a death, divorce, or other *change* in circumstance during the so-called "interval period" (the time between the partial exchange, and when the subsequent distribution occurred). So at first glance, it would appear the annuity company was reporting the transaction correctly.

However, the taxpayer's claim - and the IRS interpretation - turned out a little different. The implicit assumption of the Section 4.01(b) provision of Rev. Proc. 2008-24 was that when it said one of the conditions must have "occurred" during the interval period, that meant there needed to be a *change* in circumstances to trigger the exception if one year had not passed since the partial exchange. However, as the taxpayer claimed - and the IRS agreed - the condition should be satisfied because IRC Section 72(q)(2)(A) states that a distribution must occur "on OR AFTER the date on which the taxpayer attains age 59 1/2" (emphasis mine). Accordingly, the taxpayer claimed that 72(q)(2)(A) was a "true" condition from the moment the exchange was made - which means it was true during the interval period, and therefore "occurred" during the interval period, and therefore should be an allowable 1035 exchange.

*So what about the other exceptions?*

As some have already suggested, if the IRS will allow the partial exchange condition to be satisfied prior to the exchange - such that it is satisfied on the date the exchange is made and thereby has "occurred" during the interval period, could such a broad interpretation be applied to any exception? If the taxpayer is already divorced when the exchange is made, does that mean the condition of "divorce" is met during the interval period... even though it clearly has no relationship to the withdrawal itself and the intent of the guidance?

Fortunately (for the IRS, at least), this doesn't appear to be the case. The key trigger here was not merely the fact that a condition was true during the interval period; it's that the condition was written in the tax statute itself to apply "on OR AFTER the date on which the taxpayer attains age 59 1/2" (emphasis mine); in other words, it's the incorporation-by-reference of the explicit wording of IRC Section 72(q)(2)(A) that creates an apparently unlimited time window - that any taxpayer, any time after age 59 1/2, can complete a partial exchange and immediately follow up with a withdrawal and still avoid the Rev. Proc. 2008-24 adverse tax consequences (disqualification of the exchange). It appears, for better or for worse, that this ruling will apply primarily in the context of those who have reached age 59 1/2.

*So, then everything is ok?*

At face value, the results of PLR 201038012 seem relatively straightforward - a taxpayer who was over age 59 1/2 qualified for an exception to the partial 1035 exchange crackdown by virtue of being over age 59 1/2 at the time of the exchange.

The problem, though, is that early withdrawal penalties (and avoiding the early withdrawal penalty by being age 59 1/2) wasn't actually the original tax avoidance scheme that the partial 1035 exchange rules were designed to combat. They were designed to prevent a taxpayer from artificially converting a taxable withdrawal into a partially tax free withdrawal by reallocating basis to a new contract and then completing a withdrawal, as shown in the earlier example. Unfortunately, though, with the new interpretation under PLR 201038012 for Rev. Proc. 2008-24 when the taxpayer is over age 59 1/2, this tax avoidance strategy appears to be right back on the table!

For example, refer back to the earlier example of John Smith, who completed a partial exchange of $40,000 from a $100,000 annuity with a $60,000 cost basis. Under the "normal" partial exchange rules of Rev. Proc. 2008-24, a withdrawal from the new annuity within 12 months of the exchange would cause the $40,000 exchange to become taxable because the exchange would no longer be tax free (and the original annuity had a $40,000 gain, rendering it all taxable). As is, John could still wait one year, and then surrender the $40,000 annuity #2, and report only a $16,000 gain. But now, under PLR 201038012, as long as John is ALSO over the age of 59 ½ (before the partial exchange even occurs), then the exchange will allow for a $40,000 withdrawal IMMEDIATELY without failing the Rev. Proc. 2008-24 rules; this means the client could theoretically do the partial transfer on a Monday, and take the $40,000 withdrawal on Friday from the new annuity, and recognize only $16,000 of gain instead of $40,000 of gain (as long as he’s over age 59 ½).

The exact tax avoidance scheme that IRS Notice 2003-51 and Rev. Proc 2008-24 was designed to prevent is back on the table - and fully allowed under the safe harbors implicitly created by Section 4.01(a) and (b) - as long as the taxpayer is over age 59 1/2 when the transaction begins.

Of course, it is possible that the IRS might still apply the step transaction doctrine to a taxpayer scenario that blatantly abused these rules. Nonetheless, one might make a case that the Service should be estopped from applying such a claim if the taxpayer explicitly complied with the safe harbor guidance in Rev. Proc. 2008-24, especially given the removal in Rev. Proc. 2008-24 of the "did not contemplate at the time of the exchange" clause.

*Where to from here?*

To the extent that the Service's interpretation in PLR 201038012 appears to be sound, it would likewise appear that partial 1035 exchanges followed by immediate withdrawals to partially avoid and defer the recognition of gain is back on the table, as long as the taxpayer is over age 59 1/2 at the time of the conversion.

Nonetheless, taxpayers should likely be cautious about following the strategy too aggressively, as the implementation of such a strategy directly contravenes the IRS' intent in its guidance over the past decade, notwithstanding the apparent "loophole" that PLR 201038012 opens up. It remains to be seen whether the Service will subsequently amend Rev. Proc. 2008-24 to close the door that has been reopened.

CITATIONS:

IRC Section 72(e), 72(q)(2); IRS Notice 2003-51; Rev. Proc. 2008-24