

Contract Consolidation OK'd As 1035 Exchange

A recent IRS Revenue Ruling has changed a long-standing IRS position regarding 1035 exchanges. 1035 refers to a provision in the tax code which allows for the direct transfer of accumulated funds in a life insurance policy, endowment policy, annuity policy to another life insurance policy, endowment policy or annuity contract without creating a taxable event. Revenue Ruling 2002-75 holds that a transfer of an entire annuity contract into another pre-existing annuity contract qualifies as a tax-free exchange under IRC 1035.

David A. Wood
CLU, ChFC

Prior to Revenue Ruling 2002-75, in order to qualify as a 1035 exchange the taxpayer had to assign the annuity contract of one insurer to another insurer for a *new* contract of the second insurer. The IRS had ruled privately in 1988 that there was no valid exchange if the taxpayer transferred one contract into a pre-existing contract.

**David Wood is a
branch manager of
Jefferson Pilot
Securities
Corporation, member
[FINRA](#), [SIPC](#) and
president of
Wood Financial
Services
8 Fountain Place
Frankfort, KY 40601
502-875-5231
dawoody@fewpb.net**

An examination of the fact situation provided in Revenue Ruling 2002-75 illustrates the holding, as follows. Taxpayer A owns Contract B, an annuity contract issued by Company B, and Contract C, an annuity contract issued by Company C. Taxpayer A would like to consolidate Contract B and Contract C. Taxpayer A assigns Contract B to Company C and the entire cash surrender value of Contract B is transferred into Contract C. Taxpayer A does not receive any cash distribution from the transaction, nor does Taxpayer A pay in any additional consideration.

After the transaction, which the IRS now deems a tax-free exchange under IRC 1035, Taxpayer A's investment in Contract C is equal to the sum of her investment in Contract B and her investment in Contract C before the transaction. Similarly, immediately after the transaction, Taxpayer A's basis in Contract C is equal to the sum of her basis in Contract B and her basis in Contract C immediately prior to the transaction.

This is an important new Revenue Ruling that will dramatically impact taxpayers that would like to consolidate their annuity accounts by allowing them to 1035 into an existing annuity contract. There is no indication from the IRS that this ruling applies to life insurance contracts, and it is important to remember that with any 1035 transfer of a life insurance contract to an annuity, the distributions (not annuitization) from the annuity will be taxed on a LIFO (last in first out, which mean interest will be taxed) basis versus a FIFO (first in first out, principal is not taxed) basis of distributions from life insurance contract.

These tax-free exchanges can be useful if another annuity has features that you prefer, such as a larger death benefit, different annuity payout options, or a wider selection of investment choices.

You may, however, be required to pay surrender charges on the old annuity if you are still in the surrender charge period. In addition, a new surrender charge period generally begins when you exchange into the new annuity. This means that, for a significant number of years (as many as 10 years), you typically will have to pay a surrender charge (which can be as high as 9% of your purchase payments) if you withdraw funds from the new annuity. Further, the new annuity may have higher annual fees and charges than the old annuity, which will reduce your returns.

If you decide to do a 1035 exchange, you should talk to David Wood at 502-875-5231 or to your tax adviser to make sure the exchange will be tax-free, and make sure that it is beneficial to you.

Please note that this was designed to provide a general overview of some key points of this new Revenue Ruling and should not be construed as an analysis of the Revenue Ruling in its entirety. Neither Jefferson Pilot Securities Corporation nor its representatives provide tax or legal advice.

Time and earned interest are on your side. No matter what your retirement goal, the sooner you begin saving, the less money you'll need to contribute regularly. Longer time horizons also can boost the power of compounding for you. Contact David Wood at 502-875-5231 for more information.

**Jefferson Pilot
Securities Corporation
One Granite Place Concord, NH 03301
800-258-3648**