LIFE INSURANCE AND ANNUITY CONTRACTS WITHIN AND WITHOUT TAX QUALIFIED RETIREMENT PLANS AND LIFE INSURANCE TRUSTS

by

Lori Epstein, JD
Vice President

Barry Rabinovich, JD
Senior Director

MetLife Premier Client Group

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Within and Without Tax Qualified Retirement Plans
and Life Insurance Trusts

Presenters: Lori Epstein, JD, Vice President
Barry Rabinovich, JD, Senior Director
MetLife Premier Client Group

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Topic 2: Life Insurance Trusts

Outline

Topic 1: Life Insurance and Annuities Within and Without Retirement Plans

1. Introduction

    a. "Clients are strongly advised to consult with their own legal and tax advisors" (that's you!)

    b. Generally, in concept, receiving an immediate annuity is a lifetime income, similar to receiving Social Security or a Pension. Social Security and ERISA Qualified Pension Plans must have survivor benefits. An immediate annuity may or may not have one.

    c. Generally, in concept, retirement plans include IRAs which may be funded by using an annuity.

    d. Generally, in concept, receiving a life insurance death benefit is similar to receiving a cash inheritance.

2. Life Insurance and Annuities – Basic Product Types and Features

    a. Life Insurance
        - Underwriting is required
        - Insurable Interest is required
    b. Term Insurance
    c. Level Term Insurance
    d. Universal Life
    e. Universal Life with a Secondary Guarantee
    f. Indexed Universal Life
    g. Whole Life
    h. Second To Die
    i. New Developments

3. Annuities Held By Natural Persons – Section 72(u)

    a. Fixed Annuity Payments –vs- Non-Fixed Withdrawals
    b. Age 59 ½ Rule
    c. Generally, no underwriting required
    d. Traditional Tax Deferred Annuity
    e. Single Premium Immediate Annuity (SPIA)
    f. One Life and Multiple Lives
    g. Term Certain and Refund Certain
    h. Variable, Hybrid, Indexed Deferred Annuities
    i. Riders and Guarantees

4. Non-Tax Features of These Products

   a. As a means to achieve financial and legacy goals

      1) Pre-Retirement Survivor Income
      2) Post- Retirement Life Income
      3) Estate Liquidity
      4) Legacy Planning
      5) Charitable Giving

   b. As a means to mitigate risk

      1) Longevity risk
      2) Mortality risk
      3) Market risk
      4) Tax risk
      5) Sequence of Returns risk

   c. Product Costs and Surrender Charges

      1) There is no such thing as a free lunch
      2) Sales commissions indirectly impact product performance in that they are built into the overall cost and benefit structure of the product
      3) The cost of non-investment features and riders that provide risk management are generally deducted from cash value and thus have a direct impact on the performance of the product over time.
      4) Surrender charges are generally listed in the policy contract and, if applicable, may reduce the cash value received upon surrender.

5. Life Insurance and Annuities - Income Tax Features When Personally Owned Outside of a Retirement Plan

   a. Premium Payments (not deductible)
   b. Cash Accumulations
   c. Cash Distributions
      1) By Withdrawal – Section 72(q)
      2) By Partial Surrender
      3) By Loan – Section 72(e)(4) and Section 72(p)
      4) By Annuitizing – Section 72(b) (exclusion ratio)
      5) By Complete Surrender or Lapse

d. Death Proceeds -- Section 101, Section 72(a), (b), (c)
e. Gift – Section 102 and Section 72(e)(4)(C)
f. Pledge As Collateral Security For A Loan
g. Sale – Section 101(a)(2)
h. Exchange – Section 1035

6. Life Insurance For Participants Owned by a Retirement Plan

a. Plan must permit it
b. Plan must not discriminate
c. Unisex Rates –vs- Individual Rates
d. Incidental Benefit Rule
e. Tax on Economic Benefit
f. Deductible Contributions
g. Cannot Retain in Plan After Retirement

7. Annuities Owned by a Retirement Plan

a. 403(b) annuities / Section 457
b. IRA annuities
c. Group Annuities
d. Qualified Longevity Annuity Contracts (QLAC)

8. Owner / Beneficiary Concerns For Life Insurance

a. "Spouse" as Beneficiary and then a Divorce (State Law Issue)
b. "Spouse" is Owner and "Child" as Beneficiary (Gift Issue)
c. "Minor Child" as Beneficiary and No Will (Guardian Issue)
d. "Special Needs Dependent" as Beneficiary (Medicaid Issue)
e. "Qualified Plan" as Owner or Beneficiary (Income Tax Issue)
f. "Estate" as Beneficiary (Estate Creditor Issue)

9. Important Points to Consider

a. Products Must Be Suitable
b. Issuers Must Be Stable Financially
c. Product Illustrations Must Be Compliant

END

Topic 2: Irrevocable Life Insurance Trusts

What are some of the most important non-estate-tax driven reasons why clients use an irrevocable trust rather than simply retaining insurance or annuity contracts personally or gifting the assets directly to the beneficiary?

- To protect young or financially irresponsible heirs from spending foolishly
- To protect a current spouse as well as children from a prior marriage
- To benefit heirs who are as yet unborn
- To protect special needs beneficiaries
- To protect unmarried partners
- To protect assets from a beneficiary's creditors
- To give written instructions for a trustee to follow in order to appropriately:
    1. Exercise discretion
    2. Manage and protect assets
    3. Make distributions over a lifetime or multiple lifetimes
    4. Implement the terms of an agreement (divorce / business succession)
- To control how and when heirs receive an inheritance
- To manage the income tax aspects of receiving an inheritance

When an irrevocable trust owns life insurance on the life of the Settlor, what planning issues must be considered?

- Avoid creating an Incident of Ownership in the Insured (Section 2042)

  Example: If the trust owns cash value insurance with a long term care rider, make sure that the rider does not create an incident of ownership in the insured.
- If the trust owns term insurance, make sure the policy lasts for as long as it's needed to achieve the financial goals of the Settlor
- If the trust owns second to die insurance, make sure there is a source of future premiums to continue funding the policy after the first to die
- If the trust owns cash value insurance, make sure there is a way for the beneficiaries to benefit from the cash value during the life of the Settlor

How may irrevocable trusts be made more flexible (and less irrevocable)?

- **Grantor Powers**
  1. Power to eliminate or suspend a Crummey Beneficiary's withdrawal right
  2. Power to remove and replace the trustee
  3. Power to substitute assets of equivalent value

- **Beneficiary Powers**
  1. Grant a Testamentary Limited Power of Appointment
  2. Grant a Living Limited Power of Appointment

- **Trustee Powers**
  1. Power to amend the trust for certain purposes
  2. Power to terminate the trust early
  3. Power to delay distributions to a beneficiary currently under a financial or emotional disability
  4. Power to change to Situs of the trust for tax purposes
  5. Power to make loans to the Settlor's spouse

- **Other Provisions**
  1. Include broad distribution powers to benefit a spouse, unmarried partner or child during the life of the Settlor, such as a Spousal Lifetime Access Trust (SLAT)
  2. Include Decanting provisions
  3. Include Spendthrift protection provisions
  4. Include the appointment of a Trust Protector
  5. Provide for the future permanent disability of a beneficiary
  6. Design the trust as a Grantor Trust for income tax purposes
  7. Permit Grantor Trust status to be turned on and off
  8. Provide for a future change in the Settlor's marital status
  9. Include broad discretion for trustee to surrender existing trust owned insurance or elect a reduced paid up or extended term option using cash value

What is the proper way of transferring life insurance from a qualified retirement plan to an irrevocable trust?

- Potential disadvantages of purchasing life insurance in a qualified plan include:
  1. The ability to pay future premiums may be dependent on the ability to make future retirement plan contributions
  2. If the plan participant dies prior to retirement, the policy will be included in his or her estate
  3. The policy will have to be purchased, surrendered or distributed to the participant at retirement or plan termination (an IRA may not own life insurance so it is not possible to roll over the policy to an IRA)

- Assuming that certain enumerated conditions are met, Amendment to PTE (Prohibited Transaction Exception) 92-6, dated Feb.12,1992, permits an employee benefit plan to sell an insurance or annuity contract to:
  1. A plan participant insured
  2. A relative of a plan participant insured who is a beneficiary of the contract
  3. An employer any of whose employees are covered by the plan
  4. Another employee benefit plan, for the cash surrender value of the contract
  5. BUT NOT TO A TRUST

- Transferring individual life insurance from a qualified retirement plan to an irrevocable trust when the policy is on the life of the plan participant:

  1. Assumption: The trust is for the benefit of the family of the plan participant, including for the benefit of the spouse of the plan participant
  2. Recommendation:
     a) The plan participant insured may purchase the policy from the plan and gift it to the trust.
     b) The three year rule of IRC Section 2035 is triggered because the gift of the policy is made by the insured/decedent.
     c) To avoid the three year rule, the insured may SELL the policy to the trust so long as the trust is Grantor Trust for income tax purposes and has the cash (possibly from prior gifts) to purchase the policy
     d) The plan participant may take a cash distribution from the plan in an amount equal to the purchase price and roll over that amount into a Traditional IRA
     e) In the end, all of the cash funds used by the plan participant to effectuate this transaction end up in his or her Traditional IRA (eventually income taxable, but in the future).

  1. Assumption: The trust is for the benefit of the family of the plan participant, but NOT for the benefit of the spouse of the plan participant
  2. Recommendation:
     a) The spouse of the plan participant insured may purchase the policy from the plan and gift it to the trust.
     b) The three year rule is NOT triggered because the gift of the policy is NOT made by the insured.
     c) The plan participant may then take a distribution from the plan in an amount equal to the sales price paid and roll over that amount into a Traditional IRA
     d) In the end, all of the cash funds used by the plan participant to effectuate this transaction end up in his or her Traditional IRA (income taxable, but in the future).

When an irrevocable trust owns a non-qualified annuity, how may it continue getting tax deferral?

- The general tax treatment of tax deferred annuities under Section 72(u) is that they are tax-deferred if they are owned by a “natural person”

- When an annuity is not owned by a natural person – e.g. a corporation, partnership, LLC or other business entity – any gains in the contract will be taxable as ordinary income in the year earned.

- The exception to this “natural person rule” is that if the annuity is held by a trust as an “agent for a natural person” it will still be eligible for tax-deferral.

- In the original guidance from the Senate Report on the Tax Reform Act of 1986 (which created Section 72(u), Congress indicated that if the “nominal owner” was not a natural person, but the beneficial owner was a natural person, then the annuity would still qualify for tax deferral.

- In the context of trusts, the IRS has interpreted the rules similarly in many PLRs. See 9120024, 9204014, 9322011, 9639057, 9752035, 1999-05015, 1999-33033, and 2004-49017.

- In PLR 9316018, a Grantor Trust that owned the annuity was even allowed to retain tax deferral by the sole virtue of its grantor trust tax status alone.

- In PLR 199944020, a partnership holding an annuity was not eligible for tax-deferral because a partnership holds assets for its partners and it is not merely a nominal owner for a natural person.

- The basic conclusion to take from these PLRs is that a formal “agency” relationship need not be required for a trust to qualify as an “agent for a natural person”. Instead, all beneficiaries, both income and remainder, current and future, must be natural person.

END

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TAXATION OF NONQUALIFIED ANNUITY CONTRACTS

Inside this issue

I. Introduction:

A deferred annuity contract is an insurance contract purchased today that will provide annual (or more periodic) payments over the life of an individual or some other fixed period of time beginning at some future date. The primary reason behind the purchase of a deferred annuity is to provide retirement income, even though many individuals may not actually begin receiving distributions under their contract until many years after their retirement date. Amounts are paid into an annuity contract either in a lump sum or over a period of time. Earnings within the annuity contract grow on a tax-deferred basis, and can later be converted into a steady stream of income. This favorable tax treatment that defers income tax liability, from the growth phase to the income payment phase, has encouraged the use of annuities as a retirement savings vehicle.

A fixed annuity contract provides payments based on a guaranteed minimum rate of interest which is fixed for a period of time. Under a variable annuity contract, the portfolio is invested in equity securities and performance of the portfolio determines the amount of total payments under the contract.
The advent of the variable annuity presented policyholders with an array of investment choices. This made the annuity contract attractive to anyone who was considering equity investments yet wanted to defer the current income tax on the earnings it generates. In addition, insurers developed optional riders (for an additional cost) that offered additional benefits, such as enhanced income riders and enhanced death benefit riders. These riders provided guarantees that could not be found with other types of equity investments. Many of these riders were designed to help offset the risks

As a result, the tax-deferred annuity became a popular tax-favored investment that was often purchased by individuals with little interest in using the annuity to provide retirement income.

During the 1980's, Congress took steps to ensure that annuity contracts would be utilized primarily as retirement savings vehicles and not as a tax-sheltered investment. These changes began with the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and continued with a series of tax acts in which Congress narrowed the favorable tax treatment of annuity contracts to ensure these products favored those who used the contracts for retirement funding purposes.

This article will examine the different types of "nonqualified" deferred annuity contracts. A "nonqualified" annuity is a contract not purchased in connection with or held by a tax-qualified retirement plan and purchased with after-tax money. This article will provide examples of how distributions from nonqualified annuity contracts are taxed, explain the "non-natural person" rule, and discuss the gift and estate tax consequences of transferring a nonqualified annuity contract.

II. Types of Contracts

There are two types of nonqualified deferred annuity contracts: annuitant-driven contracts and owner-driven contracts. An annuitant-driven contract is a contract in which the contractual benefits (e.g., an enhanced death benefit) are paid upon the death of the annuitant. Individuals often purchased these contracts and named as the annuitant someone that was significantly younger in order to defer any tax for as long as possible. Congress eliminated this potentially abusive practice by enacting a new section of the Internal Revenue Code (the "Code") that mandated the distribution of the entire interest in an annuity contract within a certain period of time upon the death of any holder (owner) of the contract.[1] This provision of the Code applies to contracts issued after January 18, 1985.

An owner-driven contract is a contract in which the contractual benefits are paid upon the death of the owner. These contracts were developed so that the contractual provisions were consistent with the requirements of the Code mandating the distribution of the entire interest in the annuity contract within a certain period of time upon the death of the holder/owner. The majority of the annuity contracts being sold by insurance companies today fall into the category of owner-driven contracts.

Suggested Ownership Arrangements:
The proper titling of an annuity contract is important to ensure that the proceeds are paid in accordance with the expectations of the owner. Generally, the owner and the annuitant should be the same individual. This is true whether the contract is owner-driven or annuitant-driven and assures the payment of the policy's contractual benefits upon the death of the owner.

Many times a couple will purchase an annuity contract and automatically name both spouses as the owners of the contract. There is often little benefit to be derived by having an annuity contract jointly owned. In fact, creating joint ownership may create

[1] IRC §72(s).

misplaced expectations on the part of the owners. Most couples incorrectly assume that a jointly owned contract automatically includes a right of survivorship, but that is not always the case. Unfortunately, this mistaken perception does not come to light until after the death of one of the owners when the proceeds are paid to the designated beneficiary.

The contract proceeds will be paid to the designated beneficiary unless the contract contains a provision that provides that a surviving joint owner will contractually be designated the primary beneficiary thereby overriding any beneficiary election made by the owners. Therefore, the safest way to ensure that the proceeds are paid to the surviving owner is to designate the owners as the beneficiaries of the contract. (Later in this article we will look at an option that is only available when the designated beneficiary is the surviving spouse of the holder of the contract.)

III. Lifetime Distributions[2]

Withdrawals

Distributions from an annuity contract purchased after August 13, 1982, are taxable as ordinary income to the extent the accumulated values exceeds the investment or basis of the contract.[3] It is important to remember that all taxable distributions, even those from a variable annuity contract, will be taxed as ordinary income, and do not qualify for the reduced tax rates that apply to long-term capital gains and dividends.[4]

> Example: Peter, age 53, purchases a variable annuity contract with an initial payment of $60,000. Four years later, the contract has an accumulated value of $75,000 and a surrender value of $67,000. Peter withdraws $12,000 as a down payment on a car. Since the accumulated value ($75,000) exceeds the investment in the contract ($60,000) by $15,000, the entire $12,000 is taxed as ordinary income. Note that the surrender charge of $8,000 is ignored for purposes of determining how much of the withdrawal is taxable.[5] (The possible application of the premature distribution tax will be discussed later in this article.) If Peter had surrendered the contact in the above example, then he would only have recognized $7,000 as income, which is the difference between the investment in the contract ($60,000) and the surrender value ($67,000).

If the contract's accumulated value at the time of the distribution is less than the investment or basis in the contract, then the distribution will not be taxable nor will there be a loss generated by the withdrawal. A loss is not realized until the contract is surrendered or the benefit payments have terminated. If there is a loss after the contract

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[2] The taxation of annuity payments will be discussed in section X of this article.

[3] IRC §72(e)(2)(B)(ii). In addition, the Health Care and Education Reconciliation Act of 2010 imposes a 3.8% Unearned Income Medicare Contribution tax on the lesser of (a) net investment income, which includes (but is not limited to) interest, dividends, non-qualified annuities, royalties and rents; or (b) the taxpayer's modified adjusted gross income which exceeds the applicable threshold amount. The surtax only applies to those individuals whose modified adjusted gross income exceeds certain threshold amounts.

[4] The lower capital gains rate and the reduced qualified dividend income rate sunset on December 31, 2012.

[5] IRC §72(e)(3)(A)(i).

has either been surrendered or the benefits have terminated, then the loss may be deductible.

> Example: Marissa purchases an annuity contract in 1999 with an initial payment of $150,000. The current accumulated value of the contract is $145,000 and the surrender value is $140,000. Marissa will have an ordinary loss of $10,000 if she surrenders the contract.

If annuity payments cease because an annuitant dies before the total investment in the contract has been recovered, it is not clear whether the unrecovered basis may be allowed as a miscellaneous itemized deduction that is not subject to the 2% floor.[6]

Because of the uncertainty surrounding where on the tax return the loss should appear, the client should first discuss this issue with a competent tax advisor before taking a deduction for the loss..

Pledging and/or Loans

Pledging (or agreeing to pledge) an annuity contract as collateral or taking a loan from an annuity contract will be considered a distribution and will be taxed the same as a withdrawal. Since a loan or a pledge of (or agreeing to pledge) a policy is treated as a withdrawal, the taxable portion of the distribution is determined by looking at the accumulated value, and not the surrender value, of the contract.

> Example: Peter owns a contract with a basis of $60,000, an accumulated value of $75,000 and a surrender value of $67,000. He pledges a portion of the contract ($20,000) as collateral for a loan. Peter is considered to have received a distribution of $20,000 and will have taxable income of $15,000 and the remaining $5,000 represents a return of basis.[7]

Multiple Contracts

The change in the distribution rules from FIFO (first in first out) to LIFO (last in first out) in 1982 led some individuals to seek ways to access annuity contract values on a more tax favored basis. One way to accomplish this was through the purchase of multiple contracts. By purchasing two or more contracts, a contract owner could access basis sooner than if only one contract had been purchased.

> Example: Mr. Jones purchased an annuity contract from Company A with an initial payment of $50,000 and the contract now has an accumulated value of $90,000 (no surrender charges). Mr. Jones would have to withdraw $40,000 of taxable income before he would receive any portion of his basis. If Mr. Jones had purchased two contracts from Company A, each contract would have been worth $45,000 and would have a basis of $25,000. Therefore, Mr. Jones would be able to access the basis of Contract 1 after withdrawing only $20,000 of gain.

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[6] IRC §§ 67(b)(10), 72(b)(3). *See also* IRS Publication 575, page 22 (indicating that losses are subject to the 2% of adjusted gross income limit); and IRS Publication 529, page 12 (listing unrecovered investment in an annuity" as not subject to the 2% limit). This rule only applies where the annuity starting date is after July 1, 1986.

[7] IRC §72(e)(4)(A).

The potential for abuse was recognized and legislation was enacted which requires all annuity contracts purchased by the same policyholder, from the same insurer (or affiliate) during any calendar year to be aggregated and treated as one contract for purposes of determining the amount includable in gross income for amounts not received as an annuity .[8] This rule prevents Mr. Jones in the preceding example from accessing basis until the gain from both contracts has first been withdrawn. It is important to note that the aggregation rule does not apply to immediate annuities.[9]

While the aggregation rule has reduced the potential abuse through the purchase of multiple contracts, the aggregation rules only apply in certain instances. The rule applies to the purchase of multiple contracts by the same policyholder, from the same insurer (or affiliate) during the calendar year. Therefore, the aggregation rule does not apply if a taxpayer purchases contracts from different insurers or from the same insurer but in different calendar years. A married couple may be able to purchase two contracts from the same insurer by having each spouse own one contract. If you have a client that needs to understand how the aggregation rule applies to his/her particular set of facts and circumstances, then the client should first discuss the aggregation rule with a competent tax advisor before purchasing multiple policies.

Effective Date

The LIFO (or interest first) withdrawal rules discussed above apply to annuity contracts entered into on or after August 13, 1982 and to additional investments made on or after that date to contracts entered into before that date.[10] Pledges and/or loans from a contract issued after August 13, 1982 will be taxed on a last in first out basis (LIFO) just like a lifetime withdrawal. The aggregation rules pertaining to multiple contracts purchased by the same policyholder, from the same insurer (or affiliate) in the same calendar year apply only to contracts entered into after October 21, 1988.

IV. Premature Distributions

Section 72(q)(1) of the Code imposes an additional 10% penalty tax on the taxable portion of a premature distribution from an annuity contract It is important to remember that the penalty tax **only** applies to that part of the distribution that is taxable. Apparently, the penalty tax may not apply to contracts issued after August 13, 1982 and prior to January 18, 1985 provided the distribution is allocable to an investment made in the contract more than 10 years before the date of distribution.[11]

> Example: Bill (age 34) purchased a deferred annuity contract on September 3, 1984 with a $100,000 single payment. Bill takes a $20,000 withdrawal in 2008 when the contract is worth $265,000. The $20,000 withdrawal is income taxable

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[8] IRC §72(e)(12).

[9] H.R. Rep. No. 386, 101st Cong., 1st Sess. 665 (1989)

[10] IRC §72(e)(3)(A) and (B) and §72(e)(5)(A) and (B). According to the IRS, withdrawals from a pre-8/14/82 contract containing investments made both before and after that date will be considered to come first from the pre-8/14/82 investments, then from income associated with those investments, then from income associated with a post-8/13/82 income and finally the post-8/13/82 investment. See Rev. Rul. 85-159, 1985-2 CB 29.

[11] PL 98-369, §222(a).

but is not subject to the 10% penalty tax because the contract was purchased before the effective date of the penalty tax provision and the investment was made more than 10 years before the date of distribution.

Exceptions to the 10% Penalty Tax

Age 59 ½. There are a number of exceptions to the application of the 10% penalty tax One of the exceptions is for a distribution that occurs on or after the taxpayer attains the age of 59 ½.

> Example: Peter, age 53, purchases a variable annuity contract with an initial payment of $60,000. Four years later, the contract has an accumulated value of $75,000 and a surrender value of $67,000. Peter withdraws $12,000 as a down payment on a car. Since the accumulated value ($75,000) exceeds the investment in the contract ($60,000) by $15,000, the entire $12,000 is taxed as ordinary income. The taxable amount of the withdrawal ($12,000) is also subject to the 10% penalty tax resulting in an additional $1,200 of taxes. The penalty tax would not have applied if Peter was age 59 ½ or older at the time of the distribution.

What happens if a policy is jointly owned and one of the owners is over age 59 ½ and the other owner is under the age of 59 ½? Will the exception apply or will the penalty tax be imposed? The answer to this question is unclear since the Service has not addressed this issue. Therefore, it would be prudent for a client to address this issue with their tax advisor before taking a taxable distribution from the contract.

Will the exception to the 10% penalty tax apply when an annuity contract is owned by an irrevocable non-grantor trust? This is another issue that has yet to be addressed by the Service. It appears likely that the 10% penalty tax will apply to any taxable distribution unless one of the other exceptions applies.[12]

Death of Owner. Any payment received upon the death of a holder (owner) is an exception to the 10% penalty tax. When an annuity contract is owned by a non-natural person, the exception for the death of an owner applies upon the death of the primary annuitant. Unintended tax consequences may be incurred when the owner and annuitant of an annuitant-driven annuity contract are not the same.

> Example: Bill, age 48, owns an annuity contract (annuitant-driven) and names his father as the annuitant and names himself as the beneficiary. If Bill dies, the annuity proceeds would be paid out to the beneficiary and the 10% penalty tax would not apply because it is being paid as a result of the death of the owner. But if Bill's father dies, an annuitant- driven contract would terminate and the 10% penalty tax would apply because payment is not being made on account of the death of the owner. Therefore, the distribution does not fall within this exception.

[12] Note, however, since a non-grantor trust is not an individual, it cannot attain age 59 ½ and, as a result, the age 59 ½ exception can never apply. In contrast, the Service has indicated that if a grantor trust owns an annuity contract, the grantor is treated as the owner of the annuity for federal tax purposes and, therefore, if the grantor has attained age 59 ½, the 10% federal income tax penalty will not apply. *See* Info. Ltr. 2001-0121.

This unusual result would not occur with an owner-driven contract because these types of contracts terminate upon the death of the owner, and not the death of the annuitant, so the exception would apply.

Disability. Payments attributable to a taxpayer becoming disabled will not be subject to the penalty tax even if the taxpayer is under age 59 ½. However, this exception only applies if the taxpayer is unable to engage in any substantial gainful activity resulting from a medically determinable physical or mental impairment which can be expected to result in death or last for a long-continued and indefinite duration.[13] The requirements for this exception are similar to the Social Security definition of disabled, which means it may be difficult for a client to qualify for this exception.

Immediate Annuity. Payments made under an immediate annuity contract are not subject to the premature distribution penalty tax. An immediate annuity is defined as a contract that is purchased with a single premium or annuity consideration and annuity payments (meaning, substantially equal periodic payments made at least annually) commence no later than one year from the purchase date of the contract.[14] A section 1035 exchange of a deferred annuity contract for an immediate annuity contract will not avoid the imposition of the 10% penalty tax. The holding period of the original contract (the deferred annuity) will be added or "tacked on" to the holding period of the exchanged for contract which makes it extremely unlikely that the new contract will satisfy the Code's definition of an immediate annuity. This prevents the avoidance of the penalty tax by the simple exchange of annuity contracts.

Substantially Equal Periodic Payments (SEPP). A payment that is part of a series of substantially equal periodic payments made at least annually and for the life or life expectancy of the taxpayer or the joint life or the joint life expectancies of the taxpayer and his designated beneficiary is an exception to the 10% penalty tax.[15] The IRS has approved three methods for calculating a distribution that will satisfy the SEPP requirement.[16]

- Required Minimum Distribution Method (RMD): Simply divide the account balance by the life expectancy of the taxpayer using a table provided by the IRS. This is recalculated each year and results in payments that will differ from year to year because the account balance, and the taxpayer's life expectancy, will fluctuate from year to year.

- Amortization Method: The account balance is amortized over a period of years based upon the owner's life expectancy and using a reasonable interest rate determined on the date distributions commence. This interest rate is published by the IRS monthly and will often fluctuate from month to month. This method produces a level distribution amount each year.

[13] IRC §72(q)(2)(C) and §72(m)(7).
[14] IRC §72(u)(4), §72(q)(2)(I)
[15] IRC §72(q)(2)(D)
[16] Notice 89-25, Q&A12 and IRS Info. Ltr. 2000-0226, as modified by Rev. Rul. 2002-62; Notice 2004-15 (methods applicable to nonqualified annuities)

- Annuity Method: This method divides the account balance by an annuity factor that is derived by using an appropriate mortality table (note: the contract is not. In fact, annuitized). This will produce a level distribution amount each year.

The three methods described above will result in differing amounts satisfying the requirement for a SEPP. Generally, the largest payment will be derived using either the annuity method or the amortization method so these are often the favored choices. The owner cannot choose a specific dollar amount, nor can the owner choose to receive more or less than the amount determined under the applicable calculation method and still satisfy SEPP requirement.

It is important to remember that payments received under the SEPP exception methods discussed above will result in the distribution of income first and principal will not be recovered until after all of the income from the contract has first been distributed. In addition, amounts received under the SEPP exception must continue until the LATER of five (5) years after the date of the first payment or the owner reaches age 59 1/2. There cannot be any additional purchase payments (or transfers) to or distributions (or transfers) from the contract, nor can there be any changes to the payment stream, either an increase or decrease, before this time period has elapsed or the 10% penalty tax will apply retroactively with interest.[17]

> Example: Bill is 52 and has an annuity with an account value of $330,000 and will begin receiving distributions under the annuity method on March 1, 2014. The annuity method has been elected and he will receive payments of $20,994.92 a year without incurring a 10% penalty tax. This payment stream cannot be changed without penalty until after Bill attains age 59 ½. If Bill had been 56 when the payments had begun, then he could not change the stream of payments without penalty until after the five (5) year period had elapsed.

The IRS will allow a one-time change from either the annuity method or amortization method to the RMD method.[18] This change in policy occurred because the account values of many contracts were eroded by the downturn in the stock market and continuing with the method selected would have resulted in the rapid liquidation of the contract. However, making this one-time election when account values have dropped significantly will result in the owner receiving substantially smaller payments and these revised amounts may not meet the owner's income needs. This places the owner in the difficult position of either continuing to receive payments that may result in the early termination of the contract or accepting less money than is needed in order to continue the contract.

Final regulations effective in 2006 provide that most additional contract benefits (e.g. enhanced death benefit and guaranteed income rider) must be valued and taken into account when determining the value of a qualified annuity contract for purposes of determining a required minimum distribution (typically commencing at age 70 ½ or after the death of the qualified plan participant or IRA owner). While this requirement does not apply to nonqualified contracts, one should not be surprised if the Service later determines that the value of a nonqualified annuity contract may be greater than the contract's accumulated value.

[17] IRC §72(q)(3)
[18] See Notice 2004-15 and Rev. Rul. 2002-62.

V. Ownership by a Non-Natural Person

When an annuity contract is owned by a non-natural person, such as a corporation or partnership, then the annuity contract will lose its tax deferred status and the owner will be taxed as the income is earned and accumulated.[19] There is an exception to this rule when the non-natural person is acting as an agent for a natural person. The income on the contract is determined at the end of each year by using the following formula:

> Taxable income = (Net surrender value + all distributions received) – (Total net premiums + all amounts previously taxed)

The following examples will help illustrate this concept.

> Example: In 2011, the Acme Corporation has purchased an annuity contract with an initial payment of $70,000 and named the Vice-President of Sales as the annuitant. At the end of the year the contract has a net surrender value of $73,000. Acme must include $3,000 in income (($73,000 - $0) – ($70,000 + $0)) on its income tax return for 2011.
>
> The Company puts another $60,000 into the contract in 2012 and at the end of the year the contract has a net surrender value of $133,000. Acme has no taxable income from the annuity contract in 2012 (($133,000 + $0) – ($130,000 + $3,000)).
>
> The Acme Corporation withdraws $10,000 from the contract in 2013. The net surrender value at the end of the year is $134,000 and Acme has $11,000 of ordinary income in 2013 (($134,000 + $10,000) – ($130,000 + $3,000)).
>
> Finally, in 2014 the Acme Corporation does nothing to the contract and at the end of the year the net surrender value is $141,000. The Company has $7,000 of income in 2014 (($141,000 + $10,000) – ($130,000 + $14,000)).

Agent Exception

The non-natural person rule does not apply when the annuity contract is owned by an entity that is acting as an agent for a natural person. For example, the Service determined that tax deferral was not lost when a trust owns a group annuity contract for a group of natural persons, each with an individual account to reflect their individual interest in the group contract.[20]

There have been numerous private letter rulings issued by the Service in which an annuity contract owned by an irrevocable non-grantor trust did not result in the loss of the tax deferral. A recurring pattern in these rulings is the fact that **all** of the beneficiaries of the trust were natural persons.[21] Therefore, it is reasonable to assume that the

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[19] IRC §72(u).

[20] See PLR 200018046.

[21] See PLRs 9204014, 9204010, and 199905015. See also PLR 200018046. The Service has also indicated that if a grantor trust owns an annuity contract, the grantor is treated as the owner of the annuity for federal tax purposes and, thus, section 72(u) does not apply. *See* Info. Ltr. 2001-0121; PLR 9316018.

inclusion of a non-natural person as a beneficiary, such as a charity, may result in the loss of deferral status. In fact, the Service has previously indicated that an annuity contract owned by a charitable remainder trust will be treated as owned by a non-natural person.[22] *See Legal & Tax Trends, "Trusts as Owners of Annuity Contracts," for a more detailed discussion of this subject.*

Additional Exceptions

The non-natural person rule does not apply to an immediate annuity contract. It will also not apply (i) when the estate becomes the owner as a result of the death of the owner, (ii) if it is a qualified funding asset (used in a structured settlement), (iii) if it is an annuity held under a qualified plan, or (iv) if it is an annuity purchased by an employer upon the termination of a qualified plan and held by the employer until all amounts are distributed to the employee or his beneficiary.[23]

Even though an exception to the non-natural person rules may apply, distributions from the contract may be subject to the 10% penalty tax since a non-natural person does not have a measuring life and, therefore, cannot satisfy the age 59 ½ exception. The non-natural person rules apply to contributions made to annuity contracts after February 28, 1986.

VI. Gift of an Annuity Contract

The gift of an annuity contract issued after April 22, 1987 for less than full and adequate consideration will result in the donor being taxed on the gain at the time of the gift.[24] The amount of the gain is the difference between the investment in the contract and the cash surrender value of the contract at the time of the transfer.[25] This rule is designed to prevent the possible shifting of taxable income to someone in a lower tax bracket by subjecting the donor to immediate taxation on the gain in the contract. It is important to note that this rule generally does not apply to a distribution of an annuity contract from a non-grantor trust to the trust beneficiary named as the annuitant.[26]

Recognition of gain on the gift of an annuity will result in the donee receiving a basis in the contract equal to the donor's basis, increased by the amount of income recognized by the donor at the time of the gift.[27] This eliminates the possibility that the gain in the contract will be taxed twice.

> Example: Donor purchased an annuity contract in 1997 for a single payment of $250,000. The Donor transfers the contract to his daughter in 2008 when the contract has a cash surrender value of $285,000 and an accumulated value of $290,000. The Donor will recognize $35,000 of income in the year of the transfer and will have made a gift with a value of $285,000 to his daughter. The

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[22] See PLR 9009047.

[23] IRC §72(u)(3)

[24] For a contract issued prior to April 23, 1987, the donor will only recognize the gain that existed at the time of the transfer **if** the donee subsequently surrenders the contract. The gain will be recognized by the donor in the year in which the donee surrenders the contract. The donee will be taxed on the gain in excess of the amount of gain recognized by the donor. *See* Rev. Rul. 69-102.

[25] IRC §72(e)(4)(C).

[26] See PLRs 199905015, 9204014 and 9204010.

[27] IRC §72(e)(4)(C)(iii).

daughter's basis in the contract will be the Donor's basis of $250,000 plus the $35,000 of income recognized or $285,000.

Exception for Transfer to a Spouse or Former Spouse

The tax rules, discussed above, do not apply if the transfer is to a spouse or to a former spouse if the transfer is incident to a divorce.[28] Care must still be exercised even if the transfer will not generate a present tax liability. For example, a transfer of an annuitant-driven contract may result in the contract having a different owner and annuitant. This could create an unexpected tax liability if the annuitant were to die and the owner is under the age of 59 ½. The exception to the 10% penalty tax for distributions on account of death only applies upon the death of the owner. This result would not occur if an owner-driven contract were transferred since these contracts terminate upon the death of the owner and not the annuitant.

The exception for a transfer to a spouse or former spouse will only apply if the contract itself is transferred. Taking a withdrawal of one-half of the contract's value and giving this amount to a spouse or former spouse pursuant to a divorce decree will be treated as a distribution and may result in taxable income to the annuity owner.

Gift to a Charitable Remainder Trust

An annuity contract with substantial gain is generally not a good choice for funding a charitable remainder trust since the donor will recognize the entire gain at the time of the transfer. The tax benefit of the charitable contribution will be largely, if not entirely, offset by the recognition of income. The gift of an annuity contract to a charitable remainder trust should generally only be considered when the contract has a substantial basis and very little gain.

Transfer to a Revocable Trust

A transfer of an annuity contract to a revocable trust created by the owner of the annuity contract should not be treated as a gift that triggers the recognition of income. There is no gift[29] and, therefore, there should be no recognition of income upon the transfer of the contract to the revocable trust.

VII. Death of the Holder (Owner)

An annuity contract issued after January 18, 1985 must require the distribution of the entire interest in the annuity contract within a certain period of time upon the death of the owner. For contracts issued after April 22, 1987, the death of any owner will trigger the after-death distribution requirement of the annuity contract even when the contract is owned by a number of individuals.[30] When a non-natural person owns an annuity contract, then the primary annuitant will be treated as the owner and the contract will be distributed upon the death of the primary annuitant.[31]

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[28] IRC §1041.

[29] There is no gift because, in general, a revocable trust constitutes a grantor trust for federal tax purposes and, as the Service has indicated, if a grantor trust owns an annuity contract, the grantor is treated as the owner of the annuity for federal tax purposes. *See generally* Info. Ltr. 2001-0121.

[30] IRC §72(s)(1).

[31] IRC §72(s)(6). This rule is effective for contracts issued after April 22, 1987.

When death occurs after the annuity starting date, any remaining amount must be distributed at least as rapidly as under the method for receiving distributions prior to death. If death occurs before the annuity starting date, then the entire interest must be distributed within five (5) years of the date of death of the deceased owner. Satisfying the five-year (5) requirement does not mean that payments must be distributed in a level amount during this time. This requirement will be satisfied so long as the entire interest is distributed, whether in equal or unequal payments, within the required period.

There is an exception to the five-year (5) requirement if the designated beneficiary elects to receive distributions for his or her life (or over a period not to extend beyond the beneficiary's life expectancy). The life expectancy distribution requirement will only be met if distributions begin not later than one year after the death of the holder ry.[32] Receiving an annuity for life will satisfy this exception and the exclusion ratio would be applied to each payment until such time as the entire basis has been recovered. It is not, however, necessary to annuitize in order to qualify for this exception. Systematic distributions based upon the life or the life expectancy of the beneficiary will also qualify for this exception. However, these payments will be treated as distributions and all gain must first be distributed before a distribution of basis will occur.

Spousal Continuation

If the owner's spouse is the designated beneficiary of the annuity contract, then the surviving spouse may make an election to treat the annuity contract as his/her own.[33] This affords the surviving spouse the option of continuing the contract as if it was his/her own contract, thereby continuing the tax deferral possibly until his/her own death, or receiving payments under one of the methods discussed above.

> Example: W is the owner and the annuitant of a contract and has named her spouse, H, as the designated beneficiary. Upon W's death, H may elect to continue the contract and become the owner and the annuitant thereby postponing the tax on the income of the contract. Instead of continuing the contract as owner, H also has the option of receiving distributions within the five (5) year period or based on life expectancy. If H does not continue the contract as owner, the 10% penalty tax will not apply, regardless of H's age, because the distributions are received on account of the death of the owner.

As previously discussed, joint ownership of an annuity contract, even when the spouse is the co-owner, does not ensure that the surviving spouse may continue the contract. The only way to provide the surviving spouse with the option to continue the contract (and the tax-deferral) is to designate the surviving spouse as the beneficiary. Joint ownership alone will not afford the option of spousal continuation unless the contract by its terms designates the surviving spouse as the primary beneficiary.

VIII. Tax-Free Exchanges

A life insurance, endowment or an annuity contract may be exchanged tax-free for an annuity contract pursuant to section 1035 of the Code.[34] In general, the material terms of

[32] IRC §72(s)(2).
[33] IRC §72(s)(3)
[34] For exchanges occurring after 12/31/2009, an annuity contract may be exchanged tax free for a qualified long term care insurance contract.

the exchanged contracts must be the same. For instance, the owner must be the same on both the old and the new contract. In addition, the insured/annuitant must be the same on both the old and the new contract.[35] Caution must be exercised when exchanging a life policy, subject to a loan, for an annuity contract because the loan will be discharged or forgiven which may result in the recognition of income. The amount of the loan that is forgiven will be considered property received in addition to the exchanged for property (the annuity contract). When this occurs, then the additional property received (also referred to as "boot") will be taxable to the extent of the gain in the contract, not to exceed the amount deemed to have been received.[36]

> Example: William owns a life insurance policy with an accumulated value of $110,000, subject to a $20,000 loan, and there are no surrender charges leaving a net cash surrender value (csv) of $90,000. He has a basis in the policy of $80,000 when he decides to exchange the life policy for an annuity contract. The policy has a gain of $30,000 (($90,000 csv + $20,000 loan) - $80,000 basis = $30,000 gain) and the $20,000 loan is forgiven at the time of the exchange. The forgiven loan is considered additional property received as part of the exchange and taxable to extent of the gain, not to exceed the amount of additional property received. Therefore, since the additional property received is valued at $20,000 (the forgiven loan) and the gain at the time of the exchange is $30,000, then William will be considered to have received $20,000 of ordinary income.
>
> If the facts remain the same except the amount of the gain is $12,000, then the exchange would result in the recognition of $12,000 of income and the remaining amount ($20,000 (loan) - $12,000 (gain) = $8,000) will be considered a return of basis. The usual life insurance distribution rules do not apply when there is an exchange and property in addition to the exchanged for property is received.

In recent years the Service has issued a number of rulings that have expanded the breadth of section 1035 and created additional planning opportunities for many taxpayers. It is possible to execute a partial exchange of a contract for another contract as a result of the *Conway* decision.[37] In *Conway*, the taxpayer exchanged a portion of an existing annuity contract for a new annuity contract.[38] The basis in the new contract was apportioned in a manner that was proportionate to the amount that was transferred to the new contract. This created a potentially abusive situation since withdrawals from the new contract would enable the owner to access basis sooner than if the original contract had not been split. To combat this potential abuse the Service originally issued guidance that a withdrawal or surrender within 24 months of the exchange will be considered part of one transaction and contracts will be treated as one contract.[39]

Subsequent guidance issued by the IRS, effective for transfers that are completed on or after June 30, 2008, reduced the 24 month period to 12 months. The Service also indicated that it will not require the aggregation of the original contract(s) with the exchanged for contract(s).[40] In addition, a withdrawal on account of attainment of age 59

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[35] Treas. Reg. §1.1035-1
[36] IRC §1031(b); Treas. Reg. §1.1031(b)-1(a).
[37] IRC Conway v. Commissioner, 111 TC 350 (1998), acq. 1999-2 CB xvi..
[38] Despite the Conway ruling, not all insurance companies will recognize or accept a partial exchange.
[39] Notice 2003-51. (Superceded by Rev. Proc. 2008-24)
[40] Rev. Proc. 2008-24.

½, death or disability of the owner, or a life event such as divorce or unemployment will still be considered a tax free exchange even if the distribution occurred within the 12 month period after the exchange; however, for an exception to the 12 month rule to apply, the Service had previously taken the position that the qualifying event must have occurred between the partial exchange and the surrender or distribution.

Taxpayers had a number of complaints regarding the requirements contained in Revenue Procedure 2008-24 and the Service addressed these issues in Revenue Procedure 2011-38[41] and made the following changes effective for exchanges completed on or after October 24, 2011:

- eliminated the exceptions to the 12 month rule which were based on section 72(q) penalty tax exceptions;
- reduced the 12 month period to 180 days;
- the new 180-day requirement does not apply to amounts received as an annuity for a period of 10 or more years or during one or more lives; and
- the automatic characterization as either a tax free exchange under §1035 or a distribution taxable under §72(e) followed by a payment for a second contract is eliminated.

Note: The Service's earlier guidance (Rev. Proc. 2008-24) continues to apply to exchanges completed before October 24, 2011, with the clarification that the exceptions to the 12 month rule will apply if the qualifying event is satisfied as of the date of the withdrawal or surrender and the qualifying event does not have to occur between the date of the exchange and the withdrawal or surrender.

> Example: Mary owns an Annuity Contract A with a cash value of $100,000 (basis of $60,000) and Annuity Contract B with a cash value of $85,000 (basis of $65,000). Mary does a partial exchange of $20,000 from Contract A to Contract B. This will result in 20% of the basis of Contract A ($12,000) being transferred to Contract B. The remaining $8,000 transferred will represent gain. Contract B will end up with a cash value of $105,000 ($85,000 + $20,000) and a basis of $77,000 ($65,000 + $12,000).

For many years the insurance industry took the position that, based upon IRS rulings, a section 1035 exchange could only be made to a new policy or contract. An exchange to an existing policy or contract would not qualify because there was no exchange of one policy or contract for another policy or contract. This all changed when the Service issued a Revenue Ruling[42] in which it allowed the exchange of one annuity contract to an existing annuity contract. The Service determined that permitting this type of exchange is consistent with the legislative intent of allowing taxpayers to exchange a policy or contract for another policy or contract that better suits the taxpayer's needs.

The exchange of a corporate owned life insurance policy for an annuity contract raises some interesting issues that have not yet been addressed by the Service. Will this exchange qualify as a tax-free exchange under section 1035? Remember an annuity contract owned by a non-natural person is not considered an annuity contract for tax

[41] Rev. Proc. 2011-38.
[42] Rev. Rul. 2002-75.

purposes.[43] Applying the formula discussed above ((Net surrender value + all distributions received) – (Total net premiums + all amounts previously taxed)) will result in the gain being taxed in the year of the exchange. Therefore, it is likely that an exchange of a life insurance policy for an annuity contract may not provide the corporation with the tax deferral that had been anticipated. The result should be the same whenever an entity exchanges a life policy for an annuity contract unless the entity is acting as an agent for a natural person.

Often times the exchange of an annuity contract for another annuity contract will result in the new contract being subject to any tax law changes that otherwise may not have applied to the original contract. As a general rule, any grandfathering is lost upon the completion of the section 1035 exchange. However, the first in first out (FIFO) rules that apply to distributions from contracts that were issued prior to August 14, 1982 will continue to apply even if the contract was later exchanged for another annuity contract.[44] Contributions after August 13, 1982 will only be recovered after all gain has been distributed from the contract. If a client exchanges one of these contracts, then the client would be well advised to track their pre-August 14, 1982 contributions and remind the insurer that the amount distributed represents pre-August 14, 1982 contributions. This may help prevent the inadvertent issuance of an incorrect Form 1099-R.

As previously discussed, gain on an annuity contract is taxed as ordinary income and there is no step-up in basis upon the death of the owner. There is an exception to this rule for a variable annuity contract issued prior to October 21, 1979. These contracts may receive a step-up in basis to the policy's fair market value upon the death of the owner. Since this step-up in basis provides a tremendous benefit to the named beneficiary, these favored contracts should not generally be exchanged as the step-up in basis will be lost.[45]

IX. Estate Tax Treatment

When the owner of an annuity dies, the value of that annuity contract will be included in determining the value of the decedent's estate.[46] If the owner dies before the annuity starting date, then the cash surrender value generally represents the value of the annuity for estate tax purposes. However, the value of the annuity will be determined differently if the contract has been annuitized and there are additional payments required under the annuity option selected by the decedent. In this situation, it is the present value of the remaining payments that will be included in the decedent's estate.[47] (For a discussion of the options available to the beneficiary, please see the section entitled "Death of the Holder (Owner)".

For income tax purposes, the taxable portion of the annuity benefit paid to a beneficiary or survivor is equal to the amount in excess of the owner's basis in the annuity contract. An enhanced death benefit is not considered life insurance proceeds and, therefore, the amount of this benefit will be included in determining the taxable portion of the annuity contract. The taxable amounts received by a beneficiary will be considered income in

[43] IRC §72(u)(1).
[44] Rev. Rul.. 85-159.
[45] Rev. Rul. 79-335; PLR 9245035.
[46] IRC §2033, 2039
[47] Reg. §20.2031-7(d).

respect of a decedent or IRD.[48] Income in respect of a decedent represents income that would have been taxable to the decedent had the decedent received the income in the year of death. This income will instead be taxable to the beneficiary when received. Some examples of IRD include deferred compensation amounts, distributions from an IRA or a qualified plan, renewal commissions of a life insurance agent and annuity payments or proceeds.

An income tax deduction for a portion of the estate tax paid is allowed in order to minimize the potential double taxation on IRD payments.[49] The amount of the deduction is calculated by determining the estate tax with the taxable portion of the IRD payment in the estate and the estate tax without the taxable portion of the IRD payment in the estate. The difference represents the amount of the deduction. It is important to remember that this is a deduction that reduces taxable income as opposed to a credit, which is a dollar for dollar reduction of the tax. The IRS in Publication 559 (page 12 of 2012 version) has indicated that income in respect of a decedent creates a deduction that is not subject to the 2% limit and should appear on Line 28 of Schedule A (Form 1040).

X. Annuitization

One of the benefits of an annuity contract is the ability of an individual to receive payments over the individual's life (or life expectancy) or for the joint life (or joint life expectancy) of the individual and another person.[50] The annuity payments may also be received for a period certain or for a combination of life(s) and a period certain. The taxation of an annuity payment differs from the taxation of a withdrawal or other type of distribution. Each annuity payment generally consists of ordinary income and a return of basis. Once the total basis in the contract has been recovered, all future annuity payments will be taxed as ordinary income.

How do you determine the taxable portion of each annuity payment? The exclusion ratio determines what percentage of each annuity payment will be received income tax free. The exclusion ratio for a fixed annuity contract equals the investment in the contract divided by the expected return. For a variable annuity payment, the excludable amount is determined by dividing the investment in the contract by the number of years it is anticipated that the annuity will be paid. The following example will illustrate how the excludable potion of an annuity payment is determined.

> Example: Bill decides to begin receiving fixed annuity payments from a contract he purchased with an initial investment of $100,000. He elects the straight life option and will receive annuity payments of $15,000 a year. Bill has a life expectancy of 20 years and his expected return is $300,000. The exclusion ratio is 1/3 ($100,000 ÷ $300,000) so $5,000 of each $15,000 (1/3 x $15,000) annuity payment is received income tax free until Bill's basis of $100,000 has been fully recovered at which time all payments thereafter will be fully taxable.

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[48] IRC §691.
[49] IRC §691(c).
[50] IRC §72(a)(2) permits the partial annuitization of an existing annuity contract and the basis and gain will be prorated.

For a variable annuity payment, the excludable portion of each payment would be determined by dividing the investment ($100,000) by the anticipated term of the variable annuity payments (20 years). Therefore, $5,000 ($100,000 ÷ 20) of each annual annuity payment would be treated as a return of Bill's investment in the annuity contract and would not be taxable.

XI. Conclusion

Annuity contracts offer individuals the opportunity to save for retirement on a tax-deferred basis. These contracts, if annuitized, can help provide assurances that an individual will not outlive their retirement income. However, with these benefits comes a set of tax rules that are at times difficult to comprehend. These rules, however, must be understood to best ensure that recommendations made will not inadvertently create an unintended and unwanted tax result.

Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine-Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, and Barry Rabinovich. If you have any comments or suggestions, please contact Tom Barrett or John Donlon, Co-editors, at tbarrett@metlife.com or jdonlon@metlife.com.

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DISTRIBUTING LIFE INSURANCE CONTRACTS FROM QUALIFIED RETIREMENT PLANS

Inside this issue:

I. INTRODUCTION

Individual permanent life insurance has long been a popular feature in qualified retirement plans, particularly those maintained by small businesses. Life insurance provides an immediate and substantial pre-retirement death benefit. It can be funded with tax-deductible dollars. In certain profit sharing plans, the life insurance can be used to fulfill other business needs, such as funding a buy-sell agreement. And when a participant terminates, permanent life insurance is portable; it can be distributed from the plan and continue to provide death benefit protection for personal and estate planning purposes.

When a participant wants to retain this death benefit protection and the life insurance is distributed from a pension or profit sharing plan, there are important tax considerations. This issue of *Legal & Tax Trends* will focus on the income tax consequences of various methods of distribution, on the preservation of the cost basis built up within the life insurance policy, and on the fair market value considerations which may color the selection of a life insurance product within the qualified plan.

II. WHAT IS AN ECONOMIC BENEFIT?

Generally, employer contributions to a qualified plan do not constitute taxable income to the employee-participant in the year in which such contributions are made. The investment income earned on qualified plan assets is, likewise, exempt from federal income tax until distributed. This is because these amounts are deemed to provide a future, rather than a current, economic benefit to the employee. Employer contributions, and the earnings thereon, are considered to be retirement benefits that are usually not available to plan participants prior to separation from service.

When life insurance is a funding vehicle under a qualified plan, the rules are slightly different. The provision of current life insurance protection under the plan is deemed to provide the employee with a current economic benefit. Therefore, taxable income based on the value of the insurance protection is imputed to the insured employee while a participant in the plan.[1]The amount that is includible in the participant's income is based on the value of the pure insurance protection portion of the policy and is taxable in the year in which the premium is paid. This pure insurance or "at-risk" portion is generally equal to the excess of the face amount of the policy over its cash value.

To determine the amount that must be currently included in the employee's gross income, the at-risk portion of the policy (expressed in thousands of dollars of protection) is multiplied by a term insurance factor for each $1,000 of coverage based on the insured participant's attained age. For this purpose, the IRS has provided factors in Table 2001. This table has replaced the earlier PS-58 rates, as well as the insurance company's yearly renewable term rates, unless those rates are "generally available" and "regularly sold" by the insurer.[2] For purposes of this discussion, the term "imputed income" will be used to refer to the taxable cost of insurance protection.

III. WHAT IS COST BASIS?

In situations where the life insurance protection under a plan is provided by a cash value policy, the aggregate imputed income that is includible in the participant's income is treated as non-deductible employee contributions and therefore part of the employee's cost basis under the plan.[3] This cost basis is recoverable from the plan tax-free upon a subsequent distribution of policy benefits. For these purposes, the law differentiates between common law employees and certain self-employed individuals. An owner-employee who owns a 10 percent or less interest in an unincorporated trade or business is treated in the same manner as a common law employee; that is, the cost of the pure insurance protection provided under the plan is considered part of the owner-

[1] IRC §72(m)(3)(B)
[2] Notice 2002-8, 2002-4 I.R.B. 398
[3] IRC§72(m); Treas. Reg. §1.72-16(b)

employee's basis under the plan and is recoverable from the benefits under the policy upon distribution. On the other hand, an owner-employee who is a sole proprietor, or who owns more than a 10 percent interest in an unincorporated entity, is denied the ability to recover tax-free the aggregate imputed income from the benefits under the policy.[4]

Separate Contracts

The regulations[5] provide that the aggregate imputed income attributable to life insurance protection provided under a plan can only be recovered from the "benefits under the contract providing the life insurance protection." In some instances, application of this rule may preclude recovery of any such cost basis; for example, where a qualified plan provides both life insurance protection through a group term policy and retirement benefits funded through group annuity policies, recovery of one's cost basis will not be possible.[6]
The regulations[7] provide that under these circumstances none of the taxable insurance cost under the term policy would be considered as tax-free basis upon distribution of retirement benefits under the group annuity policy. This is because each benefit, the retirement benefit and the life insurance benefit, is considered as being provided under a separate program or contract within the plan and, upon distribution at retirement, there are no "benefits attributable, " (i.e., cash value) to the program or contract which provided the term life insurance benefit.

The regulations give an example of a plan[8] holding retirement income policies to fund life insurance and retirement benefits, and a separate investment fund to provide additional retirement benefits. The example indicates that imputed income would be recoverable against plan distributions made under the retirement income policies with respect to the benefits (i.e., cash value) attributable to those policies. The example also states that the investment fund is a separate program of benefits and is treated as a separate contract for purposes of cost recovery. Therefore, if the aggregate imputed income exceeded the cash value of the policies providing the life insurance benefit, the excess would not be recoverable from the separate investment contract.

Surrendered Contracts

The IRS has also ruled on the recovery of basis issue in a different context.[9] In that ruling, the trustee of a qualified plan surrendered cash value life insurance policies purchased on behalf of the participant and used the surrender proceeds along with side fund amounts to purchase an annuity that was then distributed to the participant. The Service held that the distribution did not represent benefits

[4] IRC§72(m)(2) and (3), and IRC §401(c)(3)
[5] Treas. Reg. §1.72-16(b)(4)
[6] It is important to note that there is no tax advantage to using individual term insurance in a qualified plan.
[7] Treas. Reg. § 1.72-2(a)(3) Example (6)
[8] Example (8) of Treas. Reg.§ 1.72-2(a)(3)
[9] Rev. Rul. 67-336, 1967-2 C.B. 66

attributable to the contract that provided life insurance protection and, therefore, the imputed income could not be recovered as basis from the annuity distributed. Thus, the ruling disallowed the tracing of the cash value from the surrender proceeds of the life insurance policy to the annuity actually distributed by the trust. The IRS, in effect, imposed the requirement that the "benefits" must be distributed under the same "contract" under which the imputed income was incurred in order to recapture the basis in the distribution.

Many practitioners have disagreed with this Revenue Ruling. Typically, in a split-funded plan where an employee separates from service and elects to take his benefit in the form of an annuity, it is standard practice to combine the insurance policy's cash value with a sufficient amount from the side fund to provide the annuity. In order to purchase an annuity that not only provides the required plan benefits, but also is cost effective for the plan, the trustee may have to "shop around." However, it appears that, based on this revenue ruling, the only way for the employee to recover the imputed income tax free from the annuity payments is to provide the annuity via the insurance policy by placing the money,(i.e., cash value plus side fund), under one of the policy's contractual settlement options.

The ruling therefore creates a frustrating situation for the trustee and the employee alike, i.e., whether to provide the annuity via the insurance policy (which may not represent the most cost effective approach) and thereby enable the employee to recover cost basis from the annuity payments, or to shop for a well-priced annuity and consequently jeopardize the employee's ability to recover the cost. Moreover, application of this revenue ruling is difficult in the "real world" where different insurance carriers may be involved in the same plan (and, therefore, multiple policies with potentially different annuity rates) and where, with the advent of newer and more competitive products, it has become common practice to replace or "upgrade" older, existing policies held under the plan.

Variable/Universal Contracts

The existing IRS regulations concerning tax-free recovery of the aggregate imputed income address the recovery of such costs under cash value policies such as whole life and retirement income policies. The regulations were promulgated prior to the demise of the retirement income contract following the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and prior to the advent of universal life and variable life insurance policies. Thus, the regulations do not specifically address such products. However, the Service has taken the position, via general information letters, that universal life and variable life are considered cash value policies for purposes of the recovery of imputed income. Therefore, the amounts previously included in income should be recoverable; as is the case with any other cash value policy.

Defined benefit plans and profit sharing plans are the types of retirement plans most likely to accommodate a life insurance policy. The selection of the

appropriate product within each type of plan is going to depend upon the client's risk tolerance, importance of accumulating cash value and the need for guarantees.

IV. WHAT IS FAIR MARKET VALUE?

In Revenue Procedure 2004-16,[10] the IRS issued its first round of guidance regarding the proper valuation of a life insurance policy being sold or distributed from a qualified plan. The IRS issued this ruling to stop the abuses surrounding the marketing concept called "pension rescue".

In pension rescue, a life insurance policy was purchased inside a qualified plan using tax-deductible dollars to pay the acquisition costs of the policy. After a few years, the policy was distributed from the plan using the policy's cash surrender value as its value for tax purposes. This amount would often be far less than the policy's fair market value. In the more egregious cases, carriers would develop special policies that were designed to have temporarily high surrender charges, artificially depressing cash surrender values. With these types of contracts, shortly after the policy was transferred out of the plan, the surrender changes would disappear and the cash values would "spring" upward. The Service stated that a proper measurement of the policy's fair market value had to be used in these situations, not an artificially depressed value. The most recent, and perhaps most conspicuous abuse involving mis-valuation of life insurance policies has occurred in connection with 412(i) planning.

In Rev. Proc. 2005-25, which superseded Rev. Proc 2004-16, the IRS substantially revised the safe harbor formulas used to calculate an insurance policy's fair market value for purposes of distributing or selling a life insurance contract from a qualified plan[11]. This Revenue Procedure takes into account previous guidance provided on establishing the market value of variable and non-variable life insurance, retirement income and endowment contracts, and it provides two safe harbor formulas to determine the value on the date of the sale or distribution from the qualified plan.

The formulas, referred to as the PERC (premiums, earnings, reasonable charges) test, are complicated but can be summarized simply as:

> [Premiums paid *plus* interest *less* reasonable mortality charges and reasonable other charges *less* any distributions, withdrawals or partial surrenders].

The formula for determining the value of a variable policy differs from the non-variable formula in that it reflects all adjustments, including investment return and market value of segregated asset accounts.

[10] Rev. Proc. 2004-16, 2004-10, I.R.B. 559, is modified and superseded
[11] Rev. Proc. 2005-25, 26 CFR 601, 201

Fair market value is the greater of the interpolated terminal reserve or the PERC amount. Currently, when a plan sponsor is distributing a life insurance policy to a plan participant, MetLife will provide the trustee (as policy owner) with the Interpolated Terminal Reserve amount, plus any unearned premium, plus pro rata dividend, reduced for any policy loans. The information may include a table of remaining policy surrender charges. At this time, MetLife, like other insurance companies, is not providing the plan sponsor with a safe harbor value; the IRS has yet to provide guidance on what constitutes *reasonable* mortality and other charges. This information is provided to the plan sponsor, who in turn advises the plan participant.

The type of policy chosen will have a profound effect on the fair market value implications, as well as on the relative cost of the coverage and cash accumulation potential. The fair market value of policies that do not have a guaranteed cash value, and those policies which may offer a secondary guarantee, can increase the value of the contract appreciably. In some instances, the value may be several times greater than the cash surrender value of the policy.

Summary

It is clear that the imputed income is recoverable tax-free as basis if the cash value policy (or policies) under which this income is incurred is the one that is actually distributed. The result should be the same where plan proceeds are applied to one of the settlement options under the insurance policy. If the insurance is provided by a term insurance policy, however, the imputed income cannot be recovered from the retirement benefits.

V. PRESERVING COST BASIS

There are many reasons why policies may be distributed from a qualified plan, but the two primary reasons are that the participant is leaving the plan, or plan provisions have changed. It is obviously desirable for the participant to retain his or her cost basis regardless of the reason for distribution, and with proper planning, trustees and plan administrators can achieve this, and potentially minimize other taxes as well.

Since the final regulations were issued in April 2002, the rules regarding distributions from qualified retirement plans have changed substantially. Most distributions, except minimum required distributions and lifetime payments are eligible to be rolled over, either into an IRA or an eligible retirement plan. Eligible rollover distributions will be subject to 20 percent withholding if not transferred directly to an IRA or another qualified plan. This may impact participants with life insurance policies, since life insurance may not be rolled into an IRA.

Of course, it is always possible for a trustee or plan administrator to surrender a permanent life insurance policy for its fair market value and make plan distributions in cash. While easy to understand and accomplish, the participant does lose the valuable life insurance protection provided by the policy, and as discussed earlier, also loses its accumulated cost basis. Perhaps the most straightforward way to look at preserving the significant tax advantages available under the qualified plan is to examine various situations in which distributions that include a life insurance policy can occur.

VI. REMOVING THE POLICY FROM THE QUALIFIED PLAN

Rollover to Another Qualified Plan

The easiest rollover to accomplish would be where a plan participant is eligible to participate in a new qualified plan that would accept both rollover plan assets and the life insurance policy. However, this option may not always be available and a rollover to an IRA may be the only alternative.

Rollover to an IRA

If there is a distribution of plan assets that includes a life insurance policy, and there is no new qualified plan to accept the rollover, the 20 percent withholding tax will apply to the taxable portion of the distribution. In this situation, the taxable portion of the policy value (i.e, the fair market value minus the cost basis) will be included in income. To satisfy the withholding requirements, the cash portion of the distribution may be reduced by the amount of tax to be withheld. Within 60 days, the participant can deposit an amount equal to the 20 percent withheld into the IRA, thereby avoiding tax on that portion of the distribution, and possibly the 10 percent premature distribution penalty tax as well.

Distributing a Policy and Retaining Cost Basis

There is a way to make a complete rollover, defer taxes, avoid withholding, retain the life insurance protection, and preserve the participant's ability to recover cost basis. The trustee or plan sponsor could take a loan against the policy's fair market value, leaving in the policy only the amount equal to the participant's cost basis. The proceeds of this loan would then be added to the participant's other side fund assets, to be rolled into an IRA. The life insurance policy could be distributed directly to the insured on a non-taxable basis, since the value would equal the recoverable cost. Withholding would not apply since the amount received would not be included in income.

But what if the policy in question has a fair market value which exceeds the cash surrender value? Since the loan amount is keyed to the cash surrender value, any policy loan will fall short of the purchase price of the policy, In this situation, what are the alternatives?

(1) To take the loan on the policy and thereby reduce the amount (but not eliminate) the taxable distribution from the plan attributable to the life insurance (Fair market value *minus* Loan amount = Taxable distribution).
(2) To skip the loan entirely and just accept the taxable distribution reduced by the cost basis.
(3) To purchase the policy outright from plan, using personal funds. In a defined contribution plan, where there is no cap on the participant's account balance, this approach will increase the value of the rollover to the IRA. In a defined benefit plan, however, this approach would be problematic. A participant's lump sum at retirement can not exceed the actuarial value of the participant's plan benefit. Exceeding this maximum lump sum could cause the plan to be disqualified. In addition, the distribution would be subject to excise tax and penalties.

Purchasing the Policy and Avoiding Withholding

Another way to affect a complete rollover, defer taxes and continue the life insurance protection would be for the plan participant to purchase the policy from the plan just prior to distribution. Special rules under Prohibited Transaction Exemption 92-6 (formerly Prohibited Transaction Exemption 77-8) allow a qualified plan to sell a life insurance contract to the insured under the policy. The insured would purchase the policy for its fair market value, allowing the trustee to roll the entire value to an IRA, thereby avoiding withholding while deferring any taxes. Again, the fair market value consideration means that this method can work well in a defined contribution plan (such as a profit sharing plan), but might be difficult if the fair market value is greater than the cash surrender value and the plan is question is a defined benefit plan. (See above.)

To retain the cost basis, the imputed income basis recovery rules require that a policy be distributed. A policy purchased in accordance with the rules of PTE 92-6 is not considered distributed, thus imputed income would not be recovered under this scenario.

VI. CONCLUSION

Life insurance maintains a useful place in qualified plans, providing a substantial, immediate death benefit. In select situations, it can fund business succession needs or other business needs. On the personal side, the portability of the policy makes coverage cost efficient to maintain beyond retirement or separation from service. While the economic benefit provided by permanent life insurance in a qualified plan can create modest imputed income today, it can also build significant cost basis To preserve this basis, trustees and plan administrators can distribute plan assets free of withholding and penalty taxes, and simultaneously preserve the most attractive features of permanent life insurance, the death benefit protection and the cost basis.

Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei and Barry Rabinovich. All comments or suggestions should be directed to tbarrett@metlife,com or jdonlon@metlife.com, Co-Editors.

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Metropolitan Life Insurance Company

200 Park Ave.
New York, NY 10166

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501 Boylston Street
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Minding Your Ts and Qs:

Inside this issue:

Comparing Qualified Plan and Non-Qualified Distributions Under Sections 72(t) and 72(q)

I. Introduction

The last couple of years the housing market has begun to rebound and the unemployment rate has been dropping. Despite the improvements in the economy, many individuals have been forced to seek other sources of income to help meet the expenses and the needs of their family. This has led many unemployed or under employed individuals to seek other sources of income to help meet their family's daily needs. For many individuals, this has meant withdrawing money from an IRA or perhaps a nonqualified annuity. How can these accounts be accessed in a tax efficient way that avoids the imposition of any penalties, but not the income taxes, on distributions from an IRA, qualified plan or nonqualified annuity?

Distributions from both qualified and non-qualified annuity contracts are subject to a 10% penalty tax unless a specific exception applies. The exceptions to the 10% penalty tax can be found in Internal Revenue Code (the Code) sections 72(q) and 72(t). While the exceptions contained in Code sections 72(q) and 72(t) are similar, there are a number of differences since 72(t) contains a number of exceptions that are not found in 72(q). Adding to this confusion is the fact that some of the exceptions found in 72(t) only apply to distributions from an individual retirement account.

II. The following chart will list many of the exceptions to the 10% penalty found in Code section 72(q) and 72(t):

72(q) exceptions (non-qualified)	72(t) exceptions (qualified)
Age 59½	Age 59½
Death of Owner	Death of Employee
Disability	Disability
Series of substantially equal periodic payments	Series of substantially equal periodic payments
Immediate annuity	Separation from service after attainment of age 55[1]
	Distribution to an unemployed individual for health insurance premiums[2]
	Higher education[3]
	First time home purchase[4]
	Medical expenses
	Qualified Reservist[5]
	Alternate payee subject to a qualified domestic relations 0rder[6]

III. Exceptions for Distributions from Non-Qualified Annuities, IRAs and Qualified Plans

The following is a more detailed discussion of the exceptions contained in the above chart:

Age 59½ - Distributions after the attainment of age 59½ are not subject to the 10% penalty.
Death of Owner/Employee – Distributions on account of the death of the owner/employee plan participant qualify as an exception.
Disability – This exception is not easily satisfied since it requires the owner/employee to be "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration."[7] The employee may be required by the

[1] This exception only applies to a distribution from a qualified plan. The Pension Protection Act of 2006 lowers the age requirement to 50 for a qualified public safety employee.
[2] This exception only applies to a distribution from an IRA.
[3] This exception only applies to a distribution from an IRA.
[4] This exception only applies to a distribution from an IRA.
[5] Added by the Pension Protection Act of 2006 and subsequently amended by the Heroes Earning Assistance and Relief Tax Act of 2008.
[6] This exception only applies to a distribution from a qualified plan.
[7] See Code section 72(m)(7).

IRS to provide proof that he/she satisfies the requirements of Section 72(m)(7) before being considered to be disabled.

Substantially Equal Periodic Payments – There are three methods of calculating payments that will qualify for the exception as substantially equal periodic payments:

> ***Required Minimum Distribution Method (RMD)*** – Divide the account balance by the life expectancy of the taxpayer using a table provided by the IRS. This method results in payments that will vary each year because of the changes to the account value and the decreased life expectancy of the taxpayer.
>
> ***Amortization Method*** – This method will provide a level amount each year and the amount is determined by amortizing the account balance based upon the taxpayer's life expectancy using a reasonable interest rate determined on the date distributions commence. The rate is published monthly by the IRS and will generally fluctuate from one month to another.
>
> ***Annuity Method*** – The account balance is divided by an annuity factor using an appropriate mortality table which produces a level amount each year (note: the contract is not annuitized under this method).
>
> Example: Peter Lynch, age 56, would like to withdraw some money from his IRA but wants to avoid the 10% penalty[8] on premature distributions. He currently has $750,000 (12/31/13 balance) in an IRA and would like to receive distributions beginning in October 2014. How much can Peter receive under each of the three options?
>
> The Amortization Method will provide Peter with an annual payment of $31768.87 while the Annuity Method will provide an annual payment of $31,668.26. The Required Minimum Distribution Method results in an annual payment of $26,132.40 ($750,000 ÷ 28.7 year life expectancy) which is the smallest amount of the three methods.[9]

In order to qualify for the substantially equal periodic exception, the distributions must be for the *later* of 5 years or until age 59 ½. Failure to satisfy this requirement will result in the application of the 10% penalty tax retroactive to the first distribution. The 10% penalty will only apply to amounts received prior to attaining age 59 ½. Any amount received in addition to the amount determined under the selected method will violate this exception and result in the retroactive application of the 10% penalty tax. The same

[8] Substantially equal periodic payments is an exception to the 10% penalty under 72(t)(2)(A)(iv). Failure to receive distributions based upon one of the three payout methods could result in the retroactive application of the 10% penalty.

[9] Assumes a distribution date of October 2014 and a reasonable interest rate of %.

result will occur if an individual receives less than the amount determined under the selected method.

> Example: Same facts as above. Peter receives his fifth annual payment in October 2019 and in November of that year withdraws $3,000. Sixty months have not elapsed from the date of the original withdrawal so the additional withdrawal invalidates the substantially equal periodic payment exception. The additional 10% penalty will be assessed against the previous withdrawals in the year in which Peter ceases receiving substantially equal periodic payments (i.e., 2019 in this example). Interest will also be imposed on the penalty tax amount for the previous years. The penalty tax will not apply to amounts received after the attainment of age 59 ½.

In Revenue Ruling 2002-62,[10] the Service expressly permits an individual using either the amortization or the annuity method to make a one time switch to the RMD method. The Service has also permitted an individual who was receiving benefits under the amortization method to recalculate this amount each year by using the taxpayer's life expectancy.[11]

IV. Exception Available for Qualified Plans and IRAs

Medical Expenses – Distributions to pay for deductible medical expenses will not be subject to the 10% penalty. The medical expenses are only deductible to the extent the medical expenses exceed 10% of adjusted gross income. What makes the determination of deductible medical expenses more difficult is that the distribution from the qualified plan or IRA will be included in adjusted gross income thereby increasing the 10% threshold and decreasing the amount of deductible medical expenses.

> Example: Tom's medical expenses for the year are $12,000. He has adjusted gross income for the year of $100,000, before taking a distribution from his IRA. The medical expenses are deductible to the extent it exceeds 10% of his adjusted gross income. Tom's deductible medical expenses are $2000 ($12,000 – [$100,000 x 10%]). Tom is able to withdraw $2,000 from his IRA, without incurring the 10% penalty, in order to pay for the deductible medical expenses. Unfortunately, the withdrawal from the IRA will increase Tom's adjusted gross income, which decreases the amount of medical expenses in excess of 10% of AGI ($12,000 – {$102,000 [$100,000 + $2,000] x 10%} $10,200 = $1,800).

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[10] See also Notice 2004-15 for a discussion of the application of Rev. Rul. 2002-62 to the substantially equal periodic exception in §72(q)(2)(D).

[11] Let Rul. 200432021. The Service also allowed a recalculation of life expectancy under the annuity method in Let. Rul. 2004032023. . The Service, in a number Letter Rulings, has allowed the taxpayer to annually recalculate the annuitization or amortization payment so long as the recalculation was calculated in the same manner as the original calculation. Caution: the taxpayer should seek their own Letter Ruling before engaging in the recalculation of their annuitization or amortization payment.

The difficulty with this exception lies in the fact that most people do not know what their adjusted gross income will be until the end of the year. This makes it difficult, if not impossible, to determine how much of the medical expenses exceeds 10% of their adjusted gross income so that the distribution falls within the exception.

V. Exception Available Only for Non-Qualified Annuity Contracts

Immediate Annuity - The annuity contract must be purchased with a single premium or annuity consideration and payments must commence no later than one year from the purchase date of the contract.[12] It is generally not possible to satisfy this exception by exchanging a deferred annuity contract for an immediate annuity under Code section 1035. The IRS has determined that the holding period of the immediate annuity contract will be the purchase date of the deferred annuity contract.[13] This makes it unlikely that the immediate annuity contract will satisfy the IRS definition under the immediate annuity exception.

VI. Exceptions Only Available for IRAs

Health Insurance Premiums for the Unemployed – The individual must have received unemployment compensation for twelve consecutive weeks under federal or state unemployment compensation law by reason of the separation. Distributions qualify for this exception if such distributions are made during the taxable year in which unemployment compensation is paid or the succeeding taxable year and the distribution does not exceed the amount paid for the health insurance for the individual, the individual's spouse and dependents. This exception will apply while the individual is unemployed or for less than 60 (sixty) days after the individual has become re-employed.

Higher Education – Distributions that do not exceed the amount of qualified higher educations expenses will not be subject to the 10% penalty. Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for enrollment. Room and board are also included for those that are at least half-time students. The payments must be to an eligible institution for the benefit of the taxpayer, the taxpayer's spouse or any child or grandchildren of either the taxpayer or the taxpayer's spouse.

First Time Home Purchase – This exception is limited to no more than $10,000 during the lifetime of the IRA owner and may be used for the benefit of the individual, the

[12] Code §72(u)/.
[13] Rev. Rul. 92-95, 1999-2 C.B. 43.

individual's spouse, any child, grandchild or ancestor of such individual or such individual's spouse. The distribution must be used before the expiration of the 120th day after the date of the distribution to pay qualified acquisition costs of a first-time homebuyer. A first-time homebuyer is someone who had no present ownership interest in a principal residence during the 2-year period ending on the date in which a binding agreement to acquire the principal residence applies. Qualified acquisition costs include the costs of acquiring, constructing, reconstructing a residence and reasonable closing costs.

VII. Exception Only Available for Qualified Plans

Separation From Service After Attainment of Age 55 – The Code provides that a distribution made to the participant when separating from service after the attainment of age 55 will not be subject to the 10% penalty. Separating from service prior to attaining age 55 and delaying distributions until the attainment of age 55 will not satisfy this exception. The plan participant must not separate from service until after the attainment of age 55.[14] However, IRS Publication 575 indicates the 10% penalty will not apply when separation from service occurs in or after the year you reached age 55 (50 for qualified public safety employees).

The Pension Protection Act of 2006 provides that a qualified public safety employee who receives distributions from a governmental defined benefit pension plan will not be subject to the 10% penalty as long as the employee separates from service after attaining age 50.[15] A qualified public safety employee is an employee of a state or a political subdivision of a state if the employee provides police protection, firefighting services or emergency medical services for any area within the jurisdiction of the state or political subdivision.

This provision is effective for distributions made after the date of enactment (August 17, 2006).

VIII. Exception Only Available for IRAs and Qualified Deferral Plans

Distributions to Reservists Called to Active Duty – This exception will apply to distributions from an IRA or attributable to elective deferrals (not the matching contributions) under a 401(k), 403(b) annuity or similar arrangement.[16] The exception will only apply if the individual is called to active duty for a period in excess of 179 days or for an indefinite period and the distribution occurs during the period beginning on the date of call to duty and ending at the close of the active duty period.[17]

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[14] See Code section 72(t)(2)(A)(v).
[15] See Code section 72(t)(10)(A).
[16] See Code section 72(t)(2)(G).
[17] Code section 72(t)(2)(G) was added by the Pension Protection Act of 2006 and originally applied only to those called to active duty after September 11, 2001 and before December 31, 2007. This provision was

This exception applies to those called to active duty after September 11, 2001.

IX. Conclusion

The exceptions to the premature distribution penalty listed above offer clients an opportunity to access their funds without the imposition of the 10% penalty tax. While there are some similarities between sections 72(q) and 72(t), there are some significant differences. An understanding of the exceptions contained in these two sections may enable the advisor to help the client meet one of the exceptions and avoid the imposition of the penalty tax.

The information contained in this correspondence is intended to be general consulting advice and is not intended to be nor should be construed as specific tax, accounting, legal or investment advice. The client must rely upon his or her professional advisor before making decisions with respect to the above discussed matters.

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amended by the Heroes Earning Assistance and Relief Tax Act of 2008 which eliminated the called to active duty before December 31, 2007 requirement.

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200 Park Avenue
New York, NY 10166

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Tax Free Rollovers Between Retirement Plans

Inside this issue:

I. Introduction

Participants in tax-sheltered retirement plans had long encountered restrictions on their ability to move funds from one type of plan to another. Included in The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were provisions titled “Increasing Portability for Participants” that expanded opportunities to move funds between plans. These provisions created planning strategies for those participants eligible for a rollover.

First, it is important to define the term *rollover*. The meaning of rollover depends on a person’s perspective. In lay terms, a rollover is the movement of assets from one tax-sheltered account to another. For those who deal with the complexities of the Internal Revenue Code and IRS regulations, the term rollover lacks precision. There are various methods for moving assets from one tax-sheltered plan to another. Sometimes the different methods may result in entirely different tax treatments. In such cases, it is critical to distinguish between these various methods.

Technically, the term *rollover* refers specifically to situations in which an individual is in personal receipt of assets from a tax-sheltered plan. The plan in question could be an employer-sponsored plan or an individual retirement arrangement (IRA). Normally, distributions would be treated as ordinary income in the year received. However, tax law has long provided an opportunity to defer taxation by *rolling* the funds into another eligible plan, provided the distributed funds were eligible for rollover. In general, tax law requires that *rollovers* be completed within 60 days of receipt.

The term *transfer* or *trustee-to-trustee transfer* is generally used to describe a method of moving assets from one IRA to another. IRA rules allow the account

holder to take a distribution and then re-contribute that amount to another IRA within 60 days in order to avoid taxes. However, tax law places limits on how often an individual can be in personal receipt of his or her IRA assets, generally once in any twelve month period. Instructing the trustee or custodian of an IRA to transfer the assets directly to another trustee, custodian, or insurer allows the account holder to avoid being in personal receipt of assets, and thus not subject to the twelve-month restriction on moving assets from one IRA to another.[1]

The term, *direct rollover,* typically refers to the transfer of a participant's assets from certain employer-sponsored retirement plans to another employer plan or to an IRA. The Unemployment Compensation Act of 1992 (UCA) imposed 20% mandatory income tax withholding on eligible rollover distributions from certain employer-sponsored retirement plans. The only way to avoid withholding is for the participant to elect a direct rollover as provided in the Act. A direct rollover means that the participant is never in personal receipt of the assets. Rather, the plan assets pass directly from the prior plan to the successor plan (or IRA).

Fortunately, most of the EGTRRA provisions regarding the transfer of assets from one plan to another apply to rollovers, trustee-to-trustee transfers and direct rollovers alike. For that reason, whenever the term rollover is used in this article, it will apply to all three variations. To the extent that a particular change is specific to a particular asset transfer technique, that fact will be explicitly noted.

II. EGTRRA Rollover Rules

As previously indicated, EGTRRA has generally liberalized the rollover rules, providing plan participants with more opportunities to move money from one plan to another.[2] In some cases, these new rules make the handling of tax-sheltered amounts more convenient. In other cases, participants are able to realize not just greater convenience, but greater tax advantages as well.

Eligible recipient plans With certain exceptions, rollovers are now permitted between all 401(a) plans (which includes 401(k) plans), 403(a) annuity plans, 403(b) plans, government 457(b) plans and regular IRAs.[3] The exceptions include, but are not limited to:

- Roth IRAs can only be rolled over to another Roth IRA.[4] Other rollovers from a Roth IRA are not permitted.

- SIMPLE IRAs can only be rolled over to another SIMPLE IRA for the first two years from the date the individual first participated in any SIMPLE IRA plan maintained by the individual's same employer. (Please note that if two years

[1] The Tax Court determined that a taxpayer can only complete one IRA to IRA rollover in a 12 month period, even where the tax payer maintains multiple IRAs. See Bobrow v/Commissioner, T.C. Memo. 2014-21.

[2] While EGTRRA changes were scheduled to expire December 31, 2010, the portions relevant to this discussion were extended indefinitely by the Pension Protection Act of 2006.

[3] Unless otherwise noted, section references are to the Internal Revenue Code or accompanying Treasury Regulations.

[4] Regs. §1.408A-10, Q & A. 5.

have expired since the employee first participated in the SIMPLE IRA plan and the employee is no longer participating in the plan, the employee may be able to treat the SIMPLE IRA as a traditional or "regular" IRA. However, if the employee continues to participate in the SIMPLE IRA beyond two years, the employee would not be able to treat the SIMPLE IRA as a "regular IRA" until the employee terminates participation in the plan.)

• In general, only pre-tax amounts may be rolled from an IRA to an employer-sponsored plan. Nondeductible, after-tax amounts may only be rolled to another IRA.

• A 401(a) plan, 403(a) plan, 403(b) plan or IRA can be rolled over to a governmental 457 plan but only to plans that separately account for rollover amounts. The separate accounting is necessary in order to preserve the 10% excise tax penalty for premature distributions since this penalty does not apply to distributions of 457 amounts, but does apply to distributions from a governmental 457(b) plan to extent the distribution is attributable to rollovers from another type of qualified retirement plan.

• No rollovers are permitted between nongovernmental tax-exempt 457 plans and other types of plans.

Severance from employment Under the pre-EGTRRA rules, participants could be eligible for a distribution and rollover if they separated from service. In determining whether or not separation from service had occurred, the *same desk rule* applied. Under the same desk rule, an employee who continued on the same job for a different employer due to a merger, acquisition or similar event is not considered to have separated from service. This rule often produced unexpected and, in the minds of many, unfair results.

- For example, consider the case of J, an employee of Company A. J is a participant in Company A's retirement plan. Company A enters into an agreement to sell J's business unit to Company B. On Friday, J leaves work as an employee of Company A and returns to work on Monday as an employee of Company B. J sits down at the same desk and continues to perform the same duties for the same customers. Under the same desk rule, J is not considered to have separated from service and would not be eligible for a distribution of the funds still held in Company A's retirement plan.

EGTRRA repealed the same desk rule. Instead, a participant may be eligible for a distribution if he or she has a severance from employment.[5] Severance from employment occurs when a participant ceases to be an employee of the employer sponsoring the plan. This rule is applicable to those who separated from service in years prior to the effective date of EGTRRA. In the previous example, this means J may be entitled to a distribution and may be able to roll those funds to an IRA or to Company B's plan. While tax law now permits distributions when there is severance from employment, a plan is not required to allow such distributions. Participants who have had or will have a severance from employment should check with their plan representatives to determine their options.

[5] IRC §§401(k)(10), 401(k)(2)(B), 403(b) and 457(d)(1).

Waiver of the 60-day rollover rule The 60-day deadline for a rollover was an absolute limit under pre-EGTRRA rules. This was true even in cases where a rollover was not completed for reasons beyond the control of the participant. For example, in certain cases a rollover was not completed on a timely basis due to erroneous advice or failures by third parties. Participants in such cases could not return these funds to another plan and were subject to income taxes and potential excise taxes on those distributions. Even if the Service had wanted to grant a waiver to the 60-day rollover period, it did not possess this authority prior to the passage of EGTRRA.

EGTRRA has granted the Secretary of the Treasury authority to waive the 60-day rule when not to do so would violate equity and good conscience.[6] The IRS issued a Revenue Procedure[7] which outlined the situations in which a taxpayer may have the 60-day rollover requirement waived and the process to obtain such waiver. Examples of situations where the 60-day rule may be waived include postal or financial institution errors, death, disability, hospitalization or incarceration. Casualty, disaster or other events beyond the control of the taxpayer may also warrant a waiver of the 60-day requirement.

Except in certain cases of administrative error that automatically qualify for waiver, one requests a waiver by applying for a private letter ruling. Over the past several years, the IRS has received a large number of such waiver requests in situations involving casualty, disaster or other events beyond the reasonable control of the individual. The IRS has usually been liberal in granting the waivers where three tests are met: (i) an administrative error, fraud, illness or similar mishap prevented the participant from rolling the distribution over within the sixty day time frame; (ii) the participant did not withdraw the distributed funds for the purpose of making personal expenditures; and (iii) the distribution was otherwise an eligible rollover distribution.

Rulings in Favor of the Taxpayer

In a 2009 Private Letter Ruling,[8] the Taxpayer decided on the 59th day to complete a 60 day rollover but was precluded because the 60th day fell on a Sunday. The Taxpayer then rolled the amount into an IRA the following day and sought a waiver, which the Service granted. In another instance, the Taxpayer completed a partial Roth conversion and later determined that his income exceeded the $100,000 limit. The Taxpayer informed the custodian of the problem and told the custodian to re-characterize back to a traditional IRA but the custodian failed to do so. The Taxpayer filed a request for relief shortly after discovering the error and the Service issued a waiver.[9] In another ruling,[10] a Taxpayer received two distributions (one in December of 2004 and the other in April of 2005) from the same IRA and due to an institutional error the monies were deposited into a non-IRA account. Because of the institutional error the Taxpayer requested a waiver of the 60 day requirement. The Service granted the waiver for the first distribution but not the second because it was not eligible to be rolled over. The Taxpayer received

[6] IRC §§402(c)(3) and 408(d)(3)(I).
[7] Rev. Proc. 2003-16, I.R.B. 2003-4, January 27, 2003.
[8] Private Letter Ruling (PLR) 200930052 (April 27,2009).
[9] PLR 200921036 (February 26, 2009).
[10] PLR 200749016 (September 12, 2009).

two distributions from the same IRA during a one year period so the waiver for the first distribution precluded the Taxpayer from rolling over the second distribution.[11]

[11] IRC §408(d)(3)(B).

Rulings Against the Taxpayer

There have also been instances where the factual situation did not fall within the guidelines of Revenue Procedure 2003-16 and denying the waiver would not be considered against equity or good conscience. The Taxpayer sought to diversify his IRA and took a distribution and rolled the money into a joint CD with his spouse. The Taxpayer's error was not discovered until the CPA noticed the taxable distribution on Form 1099-R. The Taxpayer failed to show any error by the financial institution, IRAs do not permit co-ownership by a spouse as occurred in this case, and the IRS denied the waiver request because it could not find any impediments that prevented a timely rollover.[12]

In a Private Letter Ruling (PLR)[13], the taxpayer received distributions from the deceased spouse's qualified plan and placed these amounts in a non-qualified account. The distributions, when made, were subject to the 20% withholding requirement. The Taxpayer later determined that the 20% withheld would not be sufficient to meet the income tax liability resulting from the distribution and requested a waiver of the 60 day requirement. The Service determined that the Taxpayer had no intent to complete a rollover until he discovered the tax consequences and there is no authority to grant a waiver under these circumstances.[14]

Conclusion

From these rulings it appears that the Service is willing to grant a waiver to the 60-day rollover requirement only in those instances which fall within a strict reading of Revenue Procedure 2003-16. Those situations which do not meet the criteria outlined in this Revenue Procedure have resulted in a denial of the waiver request by the Service.

Only One IRA to IRA Rollover in 12 Months A distribution from an IRA and subsequent rollover within the applicable 60 day period will not generally be taxable to the taxpayer. A subsequent distribution from the first IRA, or from the IRA that accepted the first distribution, within 12 months of the first distribution will be taxable and cannot be rolled over to another IRA.[15]

The Tax Court in Bobrow v. Commissioner determined that the one rollover per year is in the aggregate and not one rollover for each IRA maintained by the taxpayer. (Note: The proposed regulation will not be effective before January1, 2015.)[16]

- For example, Aaron has one traditional IRA (IRA #1) and takes a distribution on November 23, 2009 and rolls the distribution to an new IRA (IRA #2) on January 14, 2010. Aaron takes another distribution from IRA #3 on July 8, 2010 and would like roll this into IRA #4 but cannot because the second distribution occurred with in twelve months of the first distribution.

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[12] PLR 200919061 (February 12,2009).

[13] PLR 200817059 (February 1, 2008).

[14] See PLR 200705034 (December 6, 2006) The taxpayer understood the tax consequences, including the premature distribution penalty, and proceeded with the withdrawal. The waiver request denied since it did not fall within one of the reasons for granting a waiver. See also PLR 200809043 (December 4, 2007). Taxpayer's request was denied because her failure to timely rollover the distribution was not a result of any factors listed in Revenue Procedure 2003-16.

[15] IRC §408(d)(3)(B).

[16] See Announcement

The result in the example could have been easily avoided by Aaron if the second distribution had been completed via a trustee to trustee transfer or the amount could have been rolled over to a qualified plan (assuming the plan accepts such rollovers). There are no limitations on the number of trustee to trustee transfers that may be completed in a twelve month period. This 12 month waiting period limitation only affects IRA to IRA rollovers and does not apply to a rollover from an IRA to a qualified plan.

Rollovers from Section 457 plans Under the pre-EGTRRA rules, a rollover from an eligible 457 plan could only be made to another eligible 457 plan as a plan-to-plan transfer. Rollovers to IRAs were not permitted. EGTRRA gives participants in government 457(b) plans the option of rolling to an employer-sponsored 401(a) plan, 403(a) plan, 403(b) plan or an IRA.[17] Rollovers from a non-governmental 457 plan may *only* be rolled over to another non-governmental plan. A non-governmental plan *cannot* be rolled into a 401(a) plan, 403(a) plan, 403(b) plan or an IRA.

While a participant in a governmental 457(b) plan may be eligible to roll to an IRA or to an employer-sponsored plan, there is a potential disadvantage. Section 457 plans are deferred compensation arrangements to which the 10% federal income tax penalty for premature distributions generally does not apply, regardless of the age of the participant at the time of distribution from the 457 plan. However, there are no provisions in EGTRRA to provide for separate accounting for amounts distributed from governmental 457(b) plans in order to preserve their exemption from the premature distribution rules once rolled into another type of tax-qualified retirement plan. The potential for a 10% excise tax on early distributions from the recipient plan should be given serious consideration before rolling assets from a governmental 457(b) plan to an employer sponsored 401(a) plan, 403(a) plan, 403(b) plan or an IRA.

Rollover of hardship distributions Prior law prohibited the rollover of hardship distributions of elective deferral amounts. EGTRRA extends this prohibition to hardship distributions of all types.[18] This is one of the rare EGTRRA changes that imposes rather than removes restrictions on rollovers.

Rollover of spousal benefits Under prior law, spousal rollovers from a decedent's account were only permitted to an IRA. EGTRRA expands the surviving spouse's options, allowing the spouse to roll those funds to any 401(a), 403(a), 403(b) or governmental 457(b) plan in which the surviving spouse is a participant.[19]

Automatic rollover of "cash out" amounts In general, a plan participant must consent to a distribution from an employer-sponsored plan upon separation from service. However, there is an exception where the participant's balance is below a threshold amount, currently $5,000. In that case, the employer may force the employee to take a distribution. Typically, the employee is notified that the employer will distribute the account balance as of a specific date. Subject to the direct rollover rules, the employee may elect to have that amount transferred directly to an IRA or to another eligible plan. In the event the employee does not respond to the employer's notice, the employer will collect the required 20% withholding and distribute the remaining account balance to the participant.

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[17] IRC §457(e)(16).
[18] IRC §402(c)(4)(C).
[19] IRC §§402(c)(9), 457(e)(16), 457(b)(2), 457(d)(1)(C), 3401(a)(12)(E) and 402(f)(2)(A).

EGTRRA creates a new rule for cash out amounts in excess of $1,000. In such cases the employer will be required to roll the participant's balance to an IRA, unless the participant elects to take the balance less withholding in cash or requests a transfer to a different plan.[20] The default may no longer be a cash distribution to the participant for amounts in excess of $1,000.

Rollover of qualified plan after-tax amounts Pre-EGTRRA rules only permitted plan-to-plan transfers of after-tax amounts in an employer-sponsored plan to another plan of the same type. No rollover of after-tax amounts was permitted if the distribution was made to the participant, or if the recipient plan was an IRA. This rule no longer applies. Distributions from employer-sponsored plans that include after-tax amounts may now be rolled in full to an IRA or transferred in a direct rollover to a defined contribution plan.[21]

The fact that a participant may roll after-tax amounts may not mean that it is prudent to do so. Individuals with an IRA that includes after-tax amounts are subject to record keeping and reporting requirements that many account holders find annoying if not onerous. The record keeping requirements basically require a taxpayer to keep copies of tax records for any year in which there was an after-tax contribution to an IRA. This includes nondeductible contributions as well as after-tax amounts rolled over from employer-sponsored plans. The reporting requirements require the filing of IRS Form 8606 in any year in which there is a nondeductible IRA contribution or a distribution to a participant. This is true even if a distribution is made from an IRA that does not hold any after-tax amount. This is necessary because, if you own more than one IRA, the non-taxable portion of any distribution from any of your IRAs are required to be calculated based on the ratio of the total after-tax amount in all your IRAs over the aggregate value of all your IRAs. These requirements continue until the last dollar is distributed from the participant's last IRA. Failure to properly maintain records of these transactions may result in after-tax amounts being taxed again upon distribution. Participants considering a rollover of after-tax amounts from an employer sponsored plan to an IRA need to carefully consider whether the benefits of tax-deferral outweigh concerns regarding the record keeping and reporting burden.

Rollovers from IRAs to qualified plans In the pre-EGTRRA days, assets in an IRA could only be rolled to an employer plan if the IRA in question was a conduit IRA and the assets had to be rolled to the same type of plan that had funded the conduit IRA. For example, assets in a conduit IRA representing funds distributed from a 401(a) plan could only be rolled to another 401(a) plan. EGTRRA has expanded the permissible types of employer-sponsored plans that can receive IRA rollovers. Assets in most IRAs can be rolled to most employer-sponsored retirement plans.[22] This includes 401(a) plans, 403(a) annuity plans, 403(b) plans and government 457(b) plans. In the case of a rollover to a government 457(b) plan, a rollover is permitted only to plans that separately account for rollover amounts. This is required in order to preserve the possibility of a 10% excise tax on premature distributions since this penalty tax does not apply to distributions of 457 amounts.

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[20] IRC §§401(a)(31)(B) and 411(a)(11)(A).
[21] IRC §401(a)(31)(C) and 402(c)(2).
[22] IRC §408(d)(3).

While assets in most types of IRAs may now be rolled to an employer-sponsored plan, there are exceptions. Funds in a Roth IRA may only be rolled to another Roth IRA and may not be rolled to an employer-sponsored plan. Rollovers between Roth and non-Roth arrangements are not allowed. However, it is permissible to complete a rollover (and simultaneous Roth conversion) from an eligible retirement plan directly to a Roth IRA.[23] It is also permissible to complete rollover from a Roth 401(k) or Roth 403(b) to a Roth IRA. However, the Regulations[24] do not permit a Roth IRA to be rolled over to a Roth 401(k) or a Roth 403(b).

SIMPLE IRA amounts may not be rolled to another IRA or employer-sponsored plan within the first two years from the date the individual first participated in any SIMPLE IRA plan maintained by the individual's same employer. (Rollovers from a SIMPLE IRA are only restricted for the first two years of participation, after which time those assets would be eligible for rollover to another IRA or employer-sponsored plan.) During the first two years of participation, a SIMPLE IRA may only be rolled to another SIMPLE IRA.

Finally, after-tax amounts in an IRA may not be rolled to an employer-sponsored plan. Nondeductible IRA contributions and after-tax amounts rolled to an IRA from an employer sponsored plan may only be rolled to another IRA.

[23] IRC §408A(e)(1).
[24] Reg. §1.408A-10 Q&A-5.

Post-EGTRRA Rollover Options

From \ To	IRA	SIMPLE IRA	Roth IRA	401(a)/ 403(a) Plan	403(b) TSA	Gov 457(b) Plan	Other eligible 457 plan	Roth 401(k) Roth 403(b)	SEP IRA
IRA	✓		✓*	✓	✓	✓+			✓
Simple IRA	✓#	✓	✓#*	✓#	✓#	✓#+			✓#
Roth IRA			✓						
401(a) plan	✓		✓*	✓	✓	✓+			✓
403 (b) TSA	✓		✓*	✓	✓	✓+			✓
Governmental 457(b) plan	✓		✓*	✓	✓	✓			✓
Other eligible 457 plan							✓		
Roth 401(k) Roth 403(b)			✓					✓^	
SEP IRA	✓		✓*	✓	✓	✓+			✓

[#] Available only after two years from the date the individual first participated in any SIMPLE IRA plan maintained by the individual's same employer

* The taxable amount is includable in the taxpayer's gross income generally in the year distributed or treated as distributed from the non-Roth plan.

^ Must be transferred in a direct rollover.

[$] But only if the governmental 457(b) plan separately accounts for such rollover amounts

III. Ineligible Rollover Amounts[25]

Not all distributions from a qualified retirement plan are eligible rollover distributions so care must be exercised to avoid violating the rollover rules. A rollover to an IRA of an ineligible amount is considered an excess contribution and may result in the imposition of a 6% penalty.[26] This penalty applies until such time as the excess contribution is withdrawn (or, if applicable, absorbed by the unused portion of the annual contribution limit), unless the excess contribution is withdrawn by the due date for filing the tax return (including extensions) for the year the excess contribution was made. The income from the excess contribution must also be withdrawn and will be subject to ordinary income taxation and possibly the penalty tax on premature distributions.[27]

No rollover permitted of required minimum distributions Assume a participant is age 71 and elects to take a total distribution of $100,000 from a tax-sheltered plan. In general, the required minimum distribution divisor for an individual age 71 using the uniform lifetime tables is 26.5. $100,000 divided by 26.5 is $3,774. This would be the individual's required distribution. Since this portion of the $100,000 amount is not an *Eligible Rollover Distribution*, the amount that could be rolled to another plan in this example would be $96,226 ($100,000 less $3,774). The balance of $3,774 would be received as taxable income. However, if the participant in the example above is receiving income annuity payments from a tax-qualified defined benefit plan or an annuity contract under a tax-qualified retirement plan or IRA, the entire amount of any such income annuity payment made during or after the year in which the participant reaches age 70 ½ will be treated as an RMD and is, therefore, not eligible for rollover.

No rollover of substantially equal periodic payments Distributions from employer-sponsored plans (other than IRA based plans) made on an annual or more frequent basis (1) over the life or life expectancy of the participant, (*2*) over the joint life or joint life expectancy of the participant and a designated beneficiary, or (3) over a specified period of ten years or longer, may not be rolled over. For example, an individual who receives life annuity distributions from a pension plan would not be allowed to rollover those amounts.

No rollover permitted of certain deemed distributions A deemed distribution occurs when a participant is treated as receiving a distribution, even though no amount has actually been distributed from the plan. A common example of a deemed distribution would be where a plan loan is in default because the participant failed to make a required payment. In such situations, a participant is deemed to have received a distribution of the outstanding balance of the loan. This amount would be taxable income to the participant and subject to a 10% excise tax if the participant were under the age of 59½. The taxable cost of life insurance provided by the plan (e.g., the Table 2001 cost) represents another example of a deemed distribution. These deemed distribution amounts are not eligible rollover distributions.

No rollover permitted of excess contributions In 401(k) plans, limits are imposed on deferrals by Highly Compensated Employees (HCEs). In general, HCEs are individuals who earned more than $110,000 in the prior year (2010 limit), individuals who

[25] IRC §402(c)(4).
[26] IRC §4973(a).
[27] IRC §72(t).

earned more than $110,000 and are in the top 20% of employees based on compensation (for plans that elect the alternate definition), and more than 5% owners.[28] The deferral limit for HCEs is a function of the Average Deferral Percentage (ADP) of the non-HCE participants. If any HCE deferrals have exceeded the limit, one method of correcting this would be to return the excess deferrals. Excess deferrals returned to a participant are not eligible rollover distributions.

IV. Pension Protection Act of 2006 (PPA) Rollover Changes

Under Pre-EGTRRA and Post-EGTRRA rules, non-spousal beneficiaries were not permitted to roll inherited amounts into an IRA. If the funds were already in an IRA created by the decedent, that existing IRA could be moved from one Trustee, Custodian, or insurer to another via a Trustee-to-Trustee transfer. However, that option was not available if the funds were in a pension, profit sharing, 403(b) or governmental 457(b) plan. In the case of an employer plan, the funds would have to remain in the employer's plan until distributed.

While the rules regarding distributions to beneficiaries were generally the same for all types of plans, the available options often were not the same. Most employer plans do not include every conceivable distribution option, but generally offer a limited number of choices instead. This simplifies administration of the plan for the employer. As long as the same options are offered to all participants and beneficiaries on a nondiscriminatory basis, there is no problem for employers who choose to limit the distribution options.

This often created a tax problem for a non-spousal beneficiary. In most cases, the beneficiary was required to withdraw all of the funds within a maximum of five years following the death of the participant/account owner. The beneficiary would rarely have the option of taking distributions over his or her life expectancy, which could extend for decades in some cases. Because life expectancy distributions were rarely an option, beneficiaries were often taking amounts into current income that were far larger than they wanted or needed, paying substantial taxes in the process.

Rollover of non-spousal benefits Beginning with distributions occurring in 2007, the Pension Protection Act of 2006 allows a non-spousal beneficiary to roll funds from the employer plan (other than IRA based plans) of a decedent to an inherited IRA established by the beneficiary via a direct rollover.[29] To enhance the portability of retirement plan benefits, the Act provides that a non-spousal beneficiary can move funds from an employer plan that may have more restrictive distribution options to an IRA of his or her choice.[30] This may provide the beneficiary with more time to take distributions and an opportunity to defer income taxes for many years.

The rollover IRA established by a non-spousal beneficiary will be different from a spousal rollover in one critical respect. A spousal beneficiary can treat the IRA as his or

[28] See §416(i)(1)(B) for definition of "5% owner."

[29] The Pension Protection Act of 2006 (H.R. 4); Joint Committee in Taxation – Explanation (JCX-38-06-August 3, 2006). The IRS determined this was an optional and not a mandatory requirement for qualified plans.

[30] The Worker, Retiree, and Employer Recovery Act of 2008 amended IRC §402(c)(11) and made the direct rollover option mandatory for plan years beginning after 12/31/2009.

her own. That is, the IRA no longer belongs to the decedent, but belongs to the surviving spouse. This means, for example, that no distributions would be required prior to the year in which the spouse attains age 70 ½ and the spouse is permitted to roll funds from the IRA to an employer plan in which the spouse is a participant. With a non-spousal beneficiary, the IRA remains owned by and titled under the name of the decedent. The rollover IRA will be treated as an "inherited IRA" subject to the same distribution and transfer rules that apply to other IRAs of which the beneficiary is not the owner. No rollover is permitted to another type of plan, and if distributions are to be taken over the life expectancy of the beneficiary, they must begin not later than the year following the year of death. Otherwise, the entire balance must be distributed not later than the fifth year following the year of death. The five year option is only available when the participant dies before his or her required beginning date. There is no option to defer distributions until the beneficiary attains age 70 ½.

In general, non-spousal beneficiaries now automatically have the right to rollover funds inherited from a deceased participant in an employer-sponsored plan.[31] A non-spousal beneficiary should contact a plan representative to ensure the paperwork is properly completed to effectuate the direct rollover because a distribution to a non-spousal beneficiary is not eligible for a 60-day rollover. It also is important that the non-spousal beneficiary carefully select the IRA. If the objective is to take distributions over life expectancy, for example, the non-spousal beneficiary must determine that the IRA Trustee, Custodian, or Insurer accepts non-spousal rollovers and permits distribution over life expectancy. This may not be the true in all cases as an IRA provider may choose to be more restrictive in the available distribution options than the law permits. However, under current federal tax law, the distribution period of an inherited IRA funded by a non-spouse direct rollover may be limited, in certain instances, by the same applicable distribution period as would have been used under the employer plan if the direct rollover had not occurred. This may limit a non-spouse beneficiary's ability to take distributions over life expectancy. Due to this limitation, some IRA providers may not accept a non-spouse direct rollover from certain eligible retirement plans or will only accept such in certain limited instances.

V. Why Roll IRA Assets to an Employer-sponsored Plan?

Conventional wisdom and almost all financial service industry marketing creates the impression that participants in an employer-sponsored qualified plan who are eligible for a distribution should roll their funds to an IRA and conversely, any person with funds in an IRA should retain them in an IRA. While IRAs may be the right choice for many, employer-sponsored plans have certain features that IRAs generally lack. In many cases, rolling money from an IRA to an employer-sponsored plan can be the best strategy to accomplish the individual's objectives.

Expand investment options While employer-sponsored plans often include retail mutual funds on their investment menu, many plans also offer options that are not available to the general public. Typically, these are proprietary funds or investments with very high minimums that put them out of reach of all but a very few investors. In addition, the plans of some publicly traded companies offer employer stock as an investment option, often on a very favorable basis compared to shares purchased on the open market. Where appropriate, participants with access to these options through an

[31] Id.

employer plan may find it attractive to transfer IRA money into such plans (if the plan accepts such rollovers).

Pay life insurance premium Individuals with IRAs and a need for life insurance often ask if they can use their IRA funds to purchase the needed protection. Unfortunately, life insurance is prohibited in an IRA, but life insurance may be purchased inside many employer-sponsored plans. Once rolled from an IRA to an employer plan, these amounts may be used to pay premiums. Unlike employer contributions to the same plans, IRA amounts that are rolled into a plan by the participant are not subject to the incidental death benefit limits. Where appropriate, 100% of the transferred funds may be use to pay premium, facilitating the purchase of needed coverage.

Reduce investment expenses Reading the popular press or investment company advertising, one could easily conclude that investment options in employer-sponsored plans all have high expenses, while investments available on the open market all have low expenses. In fact, many employer-sponsored plans offer comparable (or in some cases, the same) investment options with lower expenses compared to retail products. In some cases this is true because the plan offers clone portfolios, pooled investments managed by mutual fund managers who collect a money management fee but do not impose the administrative fees of the retail mutual fund. In other cases, these plans include special classes of funds with lower expenses that are only available to institutional investors. In either case, participants in such plans may reduce their expenses by investing through an employer-sponsored plan as compared to an IRA.

Enhance creditor protection The Employee Retirement Income Security Act of 1974 (ERISA) included provisions that protect qualified plans in full from the claims of creditors. This includes both creditors of the plan sponsor as well as creditors of plan participants. The broad creditor protection provided by ERISA was confirmed in 1992 by the Supreme Court in *Patterson v. Shumate*, one of the Court's rare 9-0 decisions.[32] IRAs, on the other hand, did not enjoy the same level of federal creditor protection.

In the past, IRA protection was dependent solely on individual state law of the debtor's state of residence. There was no protection under federal bankruptcy laws. While some states granted full protection of IRA assets, many states provided only limited protection and a few states provided no protection whatsoever. Today, the situation is quite different because the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPA).

First of all, BAPA recognizes that participants in 401(a) plans, 403(b) plans and governmental plans (including 457 plans) generally enjoy unlimited protection of plan assets. In addition, BAPA extended this protection to SIMPLE IRAs, Simplified Employee Pensions (SEPs), and qualified pension and profit sharing plans with no common law employees (often referred to as "owner only" plans). Finally, BAPA provided bankruptcy protection to funds that are in transit from one plan to another. This includes direct transfer between plans and distribution from IRAs that are re-contributed to another plan within 60 days.

BAPA also provided a broad new federal bankruptcy exemption for IRAs. However, there are limits on this exemption. In general, BAPA exempts traditional and Roth IRAs

[32] 112 S.Ct. 2242 (1992).

with an "aggregate value" up to $1 million from the bankruptcy estate. BAPA also exempts rollover IRAs, and the $1 million limit does not apply to rollover amounts or earnings on those amounts as long as they came from plans with unlimited protection. This creates an added incentive for keeping IRAs that are funded with rollover contributions separate from IRAs funded with annual contributions. The unlimited protection afforded to SIMPLE IRAs, SEPs and rollover amounts may be significantly compromised if those amounts are commingled with other IRA amounts. Such commingling is common. This is even true with rollover IRAs, since EGTRRA eliminated the need to segregate funds in a conduit IRA. This led many IRA owners to combine rollover and other IRA assets for convenience and to minimize fees.

Finally, it should be noted that BAPA provides bankruptcy protection, not creditor protection. In general, IRAs are not ERISA plans and they do not qualify for the anti-alienation protections of ERISA.[33] That means that creditors could attach the IRA assets of an individual who has not sought bankruptcy protection, unless those assets were protected from creditors under the applicable state law. Even with BAPA, many IRA owners may benefit from rolling to a qualified plan if they are eligible. Once rolled into the qualified plan, the assets from the IRA may have greater flexibility in certain respects, as those funds can now be used for loans from the plan or to purchase life insurance. The rollover funds will also benefit from the broader creditor protection.

Take advantage of loan provisions Participants may not borrow from an IRA or pledge an IRA as security for a loan. Employer-sponsored plans, on the other hand, may allow loans to participants. Plan loans do involve a certain amount of risk in that loan balances may be deemed taxable distributions if not repaid in a manner that timely satisfies the loan repayment schedule (which must provide for substantially level amortization of the loan over the proscribed term) or upon termination of employment. However, plan loans can be a valuable source of credit for some participants. Rolling funds from an IRA to an employer-sponsored plan to facilitate a loan may be an appropriate strategy for those who currently need or who may need credit in the future.

Defer minimum distributions Participants with funds in an IRA must begin minimum distributions once they reach the age of 70½. This is not always the case with an employer-sponsored plan. Except for more than 5% owners, participants in an employer-sponsored plan who continue to work for the employer beyond age 70½ may defer minimum distributions until they terminate employment (assuming the plan does not require an earlier distribution). IRA account holders who are age 70½ or older and who continue to work and wish to defer taking minimum required distributions may roll their IRA assets into employer sponsored plans (which do allow such deferral) and thereby, defer distributions until after they retire.

Avoid premature distribution penalties With certain exceptions, IRA rules impose a 10% penalty tax for distributions prior to age 59½. Employer-sponsored plans are also subject to the 10% penalty tax, but are subject to some different exceptions. Employees who terminate employment in the year they attain age 55 or in any year thereafter can withdraw funds from the employer's plan at any time and in any amount with no 10% penalty tax. In such cases, moving funds from an IRA to a plan of the employer can give participants tax-favorable access to retirement plan amounts.

[33] The anti-alienation protections are found in ERISA §206(d).

Eliminate after-tax IRA amounts As discussed earlier, an IRA that includes after-tax amounts (nondeductible contributions and/or a rollover of after-tax money from an employer-sponsored plan) will saddle the account holder with additional and often burdensome record keeping and reporting requirements. In a situation where a participant takes periodic distributions over his or her life or life expectancy, these requirements could continue for decades. However, such tracking could be eliminated by rolling all pre-tax IRA amounts to an employer-sponsored plan. The entire after-tax amount, which is not eligible for rollover, could be distributed to the participant at the same time. There would be no income tax due since the amount received by the participant represents basis. In a subsequent year, the pre-tax amounts could be rolled from the employer plan back to an IRA. Since the participant's IRA would no longer include any after-tax dollars, the burdensome record keeping and reporting requirements would be eliminated.

VI. Conclusion

The rollover options provided by EGTRRA and the Pension Protection Act of 2006 expand participants' choices and create planning opportunities. As an advisor, it is critical to understand all of the planning options that are available. Only by analyzing and presenting the various planning options can clients truly maximize the substantial tax benefits available from rollovers.

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Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine-Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, and Barry Rabinovich. All comments or suggestions should be directed to co-editors, Thomas Barrett at tbarrett@metlife.com or John Donlon at jdonlon@metlife.com.

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1095 Avenue of the Americas
New York, NY 10036

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The Flexible Irrevocable Life Insurance Trust

INTRODUCTION

For many families, an irrevocable life insurance trust (ILIT) will still be a cornerstone of an estate plan even with the enhanced gift and estate tax exemption amounts provided for under the American Taxpayer Relief Act of 2012 (ATRA). The ILIT still removes the death benefit from the insured's state and federal estate. Even if no tax is likely to be due, the ILIT can protect the insurance proceeds from the beneficiary's creditors, ex-spouse and other predators.

Even with the many tax and non-tax benefits of trusts, some clients may still be hesitant to establish an ILIT as they may be concerned about the irrevocable nature of the trust. They fear that they may later regret their decision as their financial condition, the tax laws or other circumstances may change in the future. Retaining flexibility is particularly important when the trust is designed to last for more than one generation.

This article discusses how an irrevocable life insurance trust (ILIT) can be structured to be more flexible to adapt to changing family circumstances and to future changes in tax laws while still preserving the intended tax benefits. The hope is that by adding greater flexibility to address unanticipated changes, the client will have a vehicle which will better serve his or her needs as well as provide the client with a greater peace of mind in making gifts.

II. Provisions to Add Greater Flexibility - Grantor Powers

A. Ability to Change Crummey Beneficiaries

Although the grantor cannot change the beneficiaries of the ILIT, the trust agreement could give the grantor the right to cancel or modify a beneficiary's annual withdrawal rights. It is important to possess this power if a beneficiary becomes uncooperative and begins to exercise his or her withdrawal rights. This power is also attractive if the grantor wishes to cancel a particular beneficiary's withdrawal right in order to make other gifts to that beneficiary.[1] This assumes that the grantor has a sufficient number of beneficiaries to cover the gifts being made to the trust.

B. Power to Remove and Replace Trustee

Consider giving the grantor (or a beneficiary) the power to remove and replace the trustee. Revenue Ruling 95-58 gives us guidance by stating that the grantor's retention of the power to remove a trustee and appoint a successor trustee who is not related or subordinate to the grantor will not cause inclusion of the trust principal in the grantor's estate.[2] A family member or an employee would be a related or subordinate party.

C. Power to Substitute Assets

Clients who will face significant estate taxes may wish to gift highly appreciating assets to an ILIT in order to remove the future appreciation from the estate. In doing so, caution must be exercised as any asset gifted to the trust will retain its carry over or cost basis and its basis will not be stepped-up to its fair market value at death. Clients may be reluctant to gift low basis assets to an irrevocable trust if the estate tax benefits are uncertain and there will likely be a significant income tax cost in doing so.

In order to provide some tax flexibility, the grantor may wish to include a provision in the trust giving the grantor the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value[3]. With this power the grantor may be able to exchange or swap cash for an appreciated asset held in the trust, without jeopardizing the estate tax incudability of the asset and without having a taxable transaction. In this way, the appreciated asset will be brought back into the grantor's estate where it will receive a step up in basis. The grantor should have resources available in advance to make this swap power viable.

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[1] In PLR 9834004, the IRS approved a provision in an ILIT which gave the grantor the ability to cancel a beneficiary's withdrawal right, to modify the amount subject to withdrawal, and to change the period during which the beneficiary's withdrawal power could be exercised. The IRS ruled that such a provision would not cause any adverse gift or estate tax consequences.

[2] Rev. Rul. 95-58, 1995-36 IRB 16

[3] Section 675(4)(C) and Rev. Rul., 2008-22, 2008-16 I.R.B.4 796. Such a power will result in the trust being deemed a grantor trust and the grantor will be taxed on the trust's income.

III. Provisions to Add Greater Flexibility - Beneficiary Powers

A. Testamentary Powers of Appointment

The concept of a power of appointment has been an integral part of English common law for hundreds of years. This concept is also well entrenched in the laws of all fifty states and it is recognized by the federal tax code. A testamentary power of appointment allows the beneficiary to change the disposition that would otherwise occur at the beneficiary's death. For instance, a surviving spouse is often given a testamentary power of appointment over a marital or nonmarital trust. Likewise, a child can be given a testamentary power of appointment over his or her separate trust.

Usually, the testamentary power of appointment limits the permissible appointees to the grantor's descendants. If the power is limited to the grantor's lineal descendants, it will not cause the trust property to be included in the power holder's estate. However, to qualify as a limited power of appointment, the appointees may not include the power holder, the power holder's estate, the power holder's creditors, or the creditors of the power holder's estate. If the power is not so limited, it would be considered a general power of appointment and the property subject to the power is included in the power holder's estate.

A testamentary power of appointment enables the beneficiary to take a "second look" at some future time and if appropriate, change the dispositive terms of the trust, typically through a specific direction in one's will. In this way, a testamentary power of appointment can be used to adapt to changed circumstances that were unknown at the time the trust was initially drafted. A testamentary limited power of appointment is particularly useful in ILITs with generation skipping provisions because of the long duration of the trust.

Giving a beneficiary a testamentary limited power of appointment provides a great deal of flexibility as it can be designed to allow the power holder to:

(i) include future descendants;
(ii) direct that appointed assets be distributed outright or in further trust; (This may be particularly helpful if a beneficiary is incapacitated or a spendthrift or otherwise unable to handle their affairs.)
(iii) provide that it can only be exercised to delay outright distributions to the beneficiaries designated in the trust, or
(iv) limit the power holder to simply reallocating the property among various individuals or trusts created at the power holder's death. (Sometimes, this ability to reallocate is restricted to certain minimum percentages or amounts.)

When properly drafted, this testamentary limited power of appointment can be given to a beneficiary without federal gift tax consequences.[4]

B. Lifetime Powers of Appointment

Another provision which can add flexibility to an irrevocable trust is to provide someone, other than the grantor, with a living (or inter vivos) limited power of appointment (LPOA) to distribute trust income or principal (e.g., the policy's cash value or the policy itself) to a class of appointees. The inter vivos LPOA would be exercisable in the power holder's absolute discretion. So long as the power holder cannot appoint trust income or principal to himself, his estate, his creditors, or the creditors of his estate, then the assets in the ILIT will not be included in the power holder's estate.[5]

There may be gift tax consequences to the power holder if the power holder exercises the inter vivos LPOA. If the power holder is also a beneficiary of the ILIT, the power holder will be treated as having made a gift equal to the present value of all possible distributions to the power holder in the year in question.[6] If the power holder is the grantor's spouse and the power is exercised in favor of the grantor, then the unlimited gift tax marital deduction will be available to offset the gift. To avoid gift tax consequences, the grantor should name as the power holder a family member or other trusted individual who is not a beneficiary of the ILIT. In addition, the LPOA should specifically state that it cannot be exercised to the extent it would impair any existing Crummey withdrawal rights.

IV. Provisions to Add Greater Flexibility - Trustee or Trust Protector Powers

A. Power to Amend

It may be desirable to amend an ILIT in order to achieve better tax benefits or to allow administration consistent with the grantor's intent. Clearly, the grantor cannot have the power to amend the trust agreement without adverse estate tax consequences.[7] However, the trust agreement can permit an independent trustee or a "trust protector" to amend the trust subject to specific limitations.

Among the powers typically given to an independent trustee or trust protector are the power to amend the ILIT to comply with new tax laws; to amend the provisions regarding the disposition of income or principal to the beneficiaries; to add, remove or change beneficiaries; to amend the financial powers of the trustees; and to amend the provisions relating to the identity, qualifications, succession and removal of trustees. To avoid adverse gift and estate tax consequences, the independent trustee or trust protector should not be able to confer any beneficial or fiduciary interest to the grantor or be able to confer any

[4] IRC Section 2041.
[5] IRC Section 2041(b)
[6] See PLRs 200243026, 9419007 and 9451049
[7] IRC Sections 2036(a)(2) and 2038(a)(1).

beneficial interest to himself/herself, his/her estate, his/her creditors, or the creditors of his/her estate. To avoid any IRS challenge that there was an implied agreement between the grantor and the trustee or trust protector as to how he or she would carry out his or her duties, the trustee or trust protector should not be related or subordinate to the grantor.

B. Power to Terminate Trust

Changes in the trust and tax laws or in the grantor's family situation may result in the ILIT no longer serving a useful purpose. Therefore, the trust agreement should permit an independent trustee or a trust protector to terminate the ILIT. If a beneficiary-trustee has the power to terminate the trust in his/her sole discretion and as a result of such termination the beneficiary would receive all or a portion of the trust property, the power to terminate could constitute a general power of appointment for estate and gift tax purposes.[8] Therefore, the power to terminate an ILIT should be held by an independent trustee or trust protector. In addition, the spendthrift clause in the trust agreement should allow for the trust to be terminated.

C. Changing Trust Situs

It may be desirable to have the ability to change a trust's situs. Beneficiaries may move away from the jurisdiction where the grantor established the ILIT and may find it more convenient to deal with a local trustee. In such case, the local trustee may want to administer the trust under local law. Additionally, another state's laws may be better suited to the purposes and needs of the beneficiaries than the state where the trust was originally established. For example, South Dakota and Alaska have neither a rule against perpetuities nor a state income tax. If a change of trust situs is not specifically authorized in the trust agreement, a court order may be required.

A detailed analysis of the state law of the contemplated new jurisdiction is required to ensure a change in trust situs will accomplish the desired objectives without generating adverse tax consequences. For example, if changing trust situs changes the quality, value or timing of any of the powers, beneficial interests or rights of a grandfathered GST trust, the trust will lose its grandfathered status.

D. Consider Including Broad Distribution Powers - Spousal Lifetime Access Trust (SLAT)

As income and estate tax planning concerns merge, techniques that serve multiple objectives (e.g., income tax deferral, estate tax minimization, retirement and liquidity funding, asset protection) will have far greater appeal. High cash value life insurance inside an irrevocable trust and particularly spousal lifetime access trusts (SLATs) will become more attractive. A SLAT is an irrevocable life insurance trust that provides that the non-insured spouse may receive

[8] Treas. Reg. §§20.2041-1(b)(1) and 25.2514-1(b)(1).

distributions during life as well as upon the death of the insured/grantor. The insured/grantor creates an irrevocable life insurance trust and makes gifts of his or her individually owned property to the trust using his or her annual exclusions and/or applicable exclusion amount. The trustee, who is preferably an independent trustee, then applies for and purchases an insurance policy on the life of the insured/grantor. The trustee is given the power to distribute trust income and principal to the grantor's spouse. Coupled with a provision authorizing the trustee to borrow (or surrender) cash values, the grantor's spouse may have access to the policy's cash values during the grantor's lifetime. While this does not give the grantor access to cash values, provisions permitting distributions for the grantor's spouse provide flexibility.

While not recommended, if the grantor's spouse is the sole trustee of the ILIT, then the trustee's power to distribute trust income and principal to the spouse must be limited to an ascertainable standard (e.g., for health, education, maintenance and support). Otherwise, the grantor's spouse will possess a general power of appointment over the trust property causing it to be included in the spouse's estate.[9] To ensure that the assets in the ILIT are not included in the grantor's estate, the trust agreement should prohibit the trustee from using trust assets to relieve the grantor of any legal support obligations to his/her spouse. If properly structured, at the insured's death, the trustee should receive the death benefit proceeds income and estate tax free.

It is important that the grantor's spouse not make any gifts to the ILIT and that all assets transferred to the ILIT were owned by the Grantor individually. Otherwise, all or a portion of the trust principal will be included in the spouse's estate because of the spouse's retained "possession or enjoyment of the property" or the "right to the income from" the trust property.[10] Splitting gifts with the grantor does not necessarily make the spouse a grantor and implicate IRC §2036(a)(1).[11] Moreover, IRC §2036(a)(1) does not contain a "spousal unity" rule. Therefore, the spouse's access to trust property is not attributed to the grantor for purposes of that Code Section.
SLATs need to be drafted, funded and administered with care to avoid any of the above mentioned unintended tax consequences. It is important for the client to confer with his or her independent tax and legal advisors regarding the use of this technique.

E. Loans to the Grantor's Spouse

Another way for a grantor to gain indirect access to trust assets is through loans from the trustee to the grantor's spouse. The loan could be structured either as a demand loan or a term loan and should be evidenced by a promissory note bearing a rate of interest that is at least equal to the Applicable Federal Rate (AFR). While it is possible to accrue interest, it is advisable for the grantor to pay

[9] See IRC §2041(a)(2) and (b)(1)(A); Treas. Reg. §20.2041-1(c)(2).
[10] IRC §2036(a)(1)
[11] See IRC §2513(a)(1).

interest annually (and a portion of the principal over time) to avoid an IRS challenge that the loan was a sham.

Upon the earlier of the conclusion of the term or the spouse's death, the loan and cumulative interest are repaid. If the loan is outstanding at the death of the spouse, this amount should be deductible from the spouse's gross estate as a bona fide debt.[12] If the ILIT is a grantor trust, the interest payments are not subject to income taxes and are essentially a tax-free gift to the beneficiaries of the ILIT.[13]

V. Consider Utilizing "Decanting"

Decanting is the process by which the trustee exercises his or her power to distribute trust principal to a beneficiary by distributing the principal to a new trust with different terms. Decanting is essentially a "do-over". When one decants a trust, the trust principal in the original trust is distributed or "poured" into the new trust and the unwanted terms and conditions of the original trust are discarded (and the desirable terms are added).

Decanting is based upon the common-law power of the trustee to effectively amend the trust by distributing trust assets to another trust for the benefit of the same beneficiaries. Under the common law, it could be argued that the trustee who may make distributions "to or for the benefit" of a beneficiary (or beneficiaries) could make distributions to another trust for the benefit of the same beneficiary (or beneficiaries). [14]However, given the relatively modest common law authority to decant, it is generally prudent for a trustee to rely on a state decanting statute.

In the past twenty years a number of states have enacted state decanting statutes.[15] While these statutes differ on their ease of use and the amount of flexibility provided, they all authorize a trustee to effectively amend the provisions of an irrevocable trust. These statutes generally require that certain procedures be followed. For example, most decanting statutes require a writing that is signed and acknowledged by the trustee and retained with the records of the original

[12] IRC Section 2053(a)(4) and the regulation promulgated there under. Treas. Reg. Section 20.2053-7 allows a deduction for a liability contracted bona fide and for adequate and full consideration in money or money's worth.
[13] Rev. Rul. 85-13, 1985-1 CB 184, which held that a transaction between a grantor and a grantor trust of which the grantor is treated as the owner is ignored for income tax purposes.
[14] The case law of at least four states arguably recognizes a trustee's authority to distribute trust assets to another trust. The four states are Florida, Iowa, New Jersey and Massachusetts. Of these, only Florida has enacted a decanting statute. Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940); In re Estate of Spencer, 232 N.W.2d 491 (Iowa, 1975); Wiedenmayer v. Johnson, 259 A.2d 534 (N.J. Super. Ct. App. Div. 1969); Morse v. Kraft 466 Mass. 92 (2013).
[15] Since 1992, twenty-two states have enacted decanting statutes including Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Wisconsin and Wyoming. Although these statures are similar, they differ in several significant ways.

trust. The threshold issue under all of the statutes is whether the trustee has the power to decant and if so, does "decanting" violate the trustee's fiduciary duties. For example, some state statutes allow a trust with an ascertainable standard to be decanted into a discretionary trust (e.g., South Dakota, Nevada, New Hampshire) while others do not (Ohio, New York and Delaware).

Under the statutes it is the trustee and not the beneficiaries who have the power to decant. The statutes also provide that the power to decant can only be exercised in favor of one or more of the beneficiaries of the original trust. However, under some of the statutes it may be possible to add a beneficiary by giving a permissible beneficiary a limited or general power to appoint a person who was not a beneficiary of the first trust.[16] There may, however, be transfer tax consequences if a beneficiary exercises such a lifetime power of appointment.

Most statutes do not require that the beneficiary consent nor do they require court approval. However, in an effort to limit liability the trustee may seek court approval or ask the beneficiaries to consent to the decanting and to release the trustee from all liability in connection with the plan.[17] The state statutes of Arizona, Nevada, New York and North Carolina permit the trustee to seek court approval.

In many states, there are limitations on the ability of these statutes to eliminate certain rights such as a right to fixed income. On the other hand, some state statutes permit the removal of a mandatory income interest unless the tax laws require a mandatory distribution such as income rights found in a marital trust, a charitable remainder trust or a grantor retained income trust. Other states restrict the exercise of the power with respect to annual exclusion gift contributions. In addition to state statutes, the terms of the trust itself may give the trustee a power to distribute assets to another trust. This may be desirable if there is no ability to decant under the applicable state law or if the decanting provisions under state law include requirements that a grantor or his advisors consider to be undesirable.

Decanting can serve a number of useful purposes. Decanting can be used to:

(i) Modify the terms and conditions of the original trust;
(ii) Transfer the trust situs to a another jurisdiction to take advantage of more favorable legislation;
(iii) Change the trustee;
(iv) Change the administrative provisions of a trust in order to modernize the trust and make it more flexible;

[16] The Delaware statute was amended in 2007 to clarify that the trustee may grant a power of appointment to one or more beneficiaries who are proper objects of the exercise of the power in the first trust. 12 Del. C. Section 3528(a); 13 Nev. Rev. Stat. Section 163.556.
[17] Under Delaware law, for example, such releases are enforceable. 12 Del C. Section 3588

(v) Provide a mechanism for removal of the trustee or for the trustee to resign without court approval;
(vi) Expand trust powers such as the power to make loans to beneficiaries, invest in real estate, options, guarantee loans or hold concentrations of certain securities, or closely held businesses;
(vii) Bifurcate the investment responsibilities from the administrative responsibilities;
(viii) Add a spendthrift provision to the new trust;
(ix) Convert a grantor trust to a non-grantor trust or vice versa;
(x) Change state income taxation;
(xi) Split a “pot” trust into a trust with separate shares;
(xii) Include special needs or supplemental needs provisions for a beneficiary; or
(xiii) Postpone an outright distribution to a beneficiary.

In short, the number of potential uses of decanting is limiting only by the number of factual circumstances that would warrant changing the terms of an existing trust.

VI. Drafting Provisions to Add Greater Flexibility

A. Provide for Creditor Protection

Many grantors want the assets in the ILIT to either be distributed to the beneficiaries at various ages (e.g. one-half at age 25 and the balance at age 30) or they want to permit the ILIT beneficiaries to withdraw assets at those ages. In either case, the trust assets will be subject to the claims of a beneficiary's creditors, including divorced spouses at the time of distribution or at the time such assets could have been withdrawn by the beneficiary. Therefore, the grantor should consider authorizing an independent trustee (or co-trustee) to postpone distributions to a beneficiary beyond the stated ages for certain reasons (e.g., a pending divorce, bankruptcy). Such a provision, coupled with a spendthrift clause, may protect the beneficiaries from themselves, their creditors and their predators.

B. Provide for the Possibility of Future Disabled Beneficiaries

If a trust provides a beneficiary with so much of the income and principal as is necessary for the support of the beneficiary, the trust is referred to as a "support" trust. If the beneficiary of a support trust is receiving government assistance or becomes eligible for Supplemental Security Income after the ILIT is established, then the support trust may be subject to claims for reimbursement by the governing state.

It may be advisable to include a "fail-safe" provision in the trust agreement which "converts" a support trust into a discretionary special needs trust if the beneficiary becomes eligible for government assistance. A discretionary special needs trust allows the trustee, in the trustee's sole discretion, to provide the

beneficiary with income and principal as needed for the beneficiary's supplemental needs without disqualifying the beneficiary for government assistance. Generally, the discretionary special needs trust provides the beneficiary with the supplemental needs not being covered by public assistance, such as reading materials, travel expenses, and clothes. Since the beneficiary does not have an ascertainable interest in a discretionary trust, the beneficiary's creditors may not be able to reach the assets in the trust.

C. Design the Trust as a Grantor Trust for Added Flexibility

Consideration should also be given to designing the trust as a "grantor trust" for income tax purposes only.[18] Grantor trust status is achieved by intentionally violating one or more of the grantor trust rules so that both the income and principal of the trust are taxed to the grantor. However, care must be taken because some of the provisions that trigger grantor trust status will also cause trust assets to be included in the grantor's estate for federal and state estate tax purposes.

If income producing assets are gifted to the ILIT to pay premiums, the grantor's payment of the ILIT's income taxes will be the equivalent of a tax-free gift to the beneficiaries of the ILIT.[19] The same favorable income tax result would occur if an ILIT sold an asset and incurred a gain on the sale.

Furthermore, if the grantor wishes to sell a policy owned by an existing ILIT to a new ILIT (with provisions more to the grantor's liking), the IRS has ruled that if both ILITs are grantor trusts, transfers between the two ILITs are disregarded for income tax purposes.[20] Thus, the transfer-for-value rule is not triggered.[21] Moreover, if the existing ILIT is not a grantor trust but the new ILIT is, the sale of a policy insuring the grantor's life to the new ILIT does not trigger the transfer-for-value rule because of the exception to that rule for transfers to the insured.[22] In addition, the three-year rule will not apply because that rule only deals with gifts and not to bona fide sales for full and adequate consideration.[23]

When selling policies to or between ILITs, in order to avoid potential gift tax issues and to fall within the bona fide sale exception, the purchase price must be the policy's fair market value. Generally, that value is the policy's interpolated terminal reserve amount plus the unearned premium.[24]

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[18] IRC §§673 through 677.
[19] In Rev. Rul. 2004-64, 2004-2 IRB 7, the IRS ruled that the payment of tax on income and gains of a grantor trust by the grantor is not a taxable gift to the beneficiaries of the grantor trust.
[20] Rev. Rul. 2007-13, 2007-11 IRB 684
[21] IRC §101(a)(2)

[22] Rev. Rul. 2007-13, 2007-11 IRB 684
[23] IRC §2035(b)(1).
[24] Treas. Reg. §25.2512-6(a), Ex. 4. Where the insured is uninsurable or in poor health, the interpolated terminal reserve value may be less than fair market value. See Estate of Pritchard v Comm'r, 4 TC 204 (1944) and Treas. Reg. §25-2512-1. Therefore, in situations where the insured is uninsurable or in poor health, it may be advisable to

D. Change in Marital Status

In the typical ILIT, the grantor's surviving spouse is often the primary beneficiary after the grantor's death. The spouse may also be named as a trustee. In addition, the spouse may have a testamentary limited power of appointment over the trust property.

In the event of divorce, most grantors will no longer want their spouse to be a beneficiary, trustee or power holder under their trust. The trust could provide that, in the event of legal separation or divorce, the grantor's spouse shall be deemed for all purposes of interpreting the trust to have predeceased the grantor. Furthermore, the grantor's "spouse" could be defined in the trust agreement to mean that person the grantor is married to at the time of the grantor's death.

VII. Conclusion

While adding flexibility to irrevocable trusts should always be considered, it may not be appropriate in every situation. There may be tension between maximizing flexibility and assuring that the grantor's intent will be maintained. In addition, there are costs to draft additional flexibility into the trust as the added powers must be drafted to conform to the grantor's and the beneficiary's circumstances. In all situations, clients should work with their tax and legal advisors to ensure their trust documents are drafted in a manner that best fits their needs.

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obtain the fair market value of a policy by pricing the policy in the life settlement market. In addition, if there are potential purchasers for the policy in the after-market, the after-market value may trump the traditional life insurance valuation rules (which predate the life settlement market) in favor of the willing buyer/seller test of Treas. Reg. Sec. 25.2512-1.

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Metropolitan Life Insurance Company
200 Park Avenue
New York, NY 10166

New England Life Insurance Company
501 Boylston Street
Boston, MA 02116

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Inside this issue

Trusts as Owners of Non-qualified Annuity Contracts

In this issue of *Legal & Tax Trends* we examine the tax and planning issues presented when a trust is the owner of an annuity contract. At the heart of the discussion is the so called non-natural person rule of IRC section 72(u) which denies tax deferred treatment to annuity contracts that are owned by a non-natural person such as a trust or corporation. This issue will explore the exceptions to the rule, as interpreted by the Internal Revenue Service in rulings, and discuss some potential planning opportunities. But be aware that the lack of guidance from the Service continues to make this a difficult area to navigate.

I. INTRODUCTION

The income taxation of annuity contracts is governed by Internal Revenue Code section 72.This code provision underwent extensive revision as a result of the tax simplification and reform measures of the 1980s. The legislation was intended to discourage the use of annuity contracts as short-term investments and instead be used as long-term retirement savings vehicles. To this end, the legislation fundamentally altered the manner in which amounts withdrawn from annuities are taxed, and imposed tax penalties on income withdrawn prior to the contract holder's attaining age 59 ½. In addition, Congress added a new Code provision, section 72(u), which denies tax-deferred treatment to any annuity that is not held by a natural person (subject to certain exceptions).

Section 72(u) was designed to discourage the practice, then in use by corporations, of purchasing annuity contracts to informally fund non-qualified deferred compensation arrangements. As stated in the legislative history to section 72(u):

> "The committee believes that the present-law rules relating to deferred annuity contracts present an opportunity for employers to fund, on a tax-favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment may create a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions."[1]

Congress was concerned that the disincentive to provide qualified pension plan benefits undermined the non-discrimination rules of qualified plans by encouraging employers to establish non-qualified plans which could only be offered to a limited class of employees.

II. THE NON-NATURAL PERSON RULE

Section 72(u)(1) provides that "If any annuity contract is held by a person who is not a natural person (A) such contract shall not be treated as an annuity contract for purposes of [Subtitle A (Income Taxes) of the Internal Revenue Code] . . . (other than subchapter L) and (B) the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year. For purposes of this paragraph, holding by a trust or other entity as an agent for a natural person shall not be taken into account."

The language of section 72(u)(1) is quite straightforward—an annuity contract will not be treated as an annuity contract, and will therefore not provide tax deferral, if it is owned by a non-natural person. If, however, the non-natural person is merely holding the contract as an agent for a natural person, this rule will not apply and deferral will be available. The critical question then, is under what circumstances such an agency arrangement will be deemed to exist. Unfortunately, neither the Code nor the

[1] S. Rep. No. 99-313, at 567 (1986).

regulations provide any explanation, although the legislative history provides the following example:

> "In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person. Thus, if a group annuity contract is held by a corporation as an agent for natural persons who are the beneficial owners of the contracts, the contract is treated as an annuity contract for Federal income tax purposes."[2]

The Service did issue a ruling in which it determined that a trust created by an employer for the benefit of the employees was acting as an agent for natural person(s) when it purchased a group annuity contract and each employee received a certificate.[3] The employees were presently taxed on employer contributions and while the plan was subject to ERISA it was not intended to be a qualified plan. The same employer was making some changes to the group annuity contract and requested a new ruling that the contract qualified as an annuity under §72. Another favorable ruling was issued by the Service in which it stated that the group annuity contract continues to qualify under §72.[4]

In addition to the exception for contracts held by an entity as an agent for a natural person, there are five specific exceptions to the non-natural person rule set out in section 72(u)(3). The exceptions are applicable to any annuity contract that:

1. is acquired by the estate of a decedent by reason of the death of the decedent;

2. is held under a qualified retirement plan, a 403(a) plan, a 403(b) program, or an individual retirement plan;

3. is a qualified funding asset (as defined in section 130(d));

4. is purchased by an employer upon termination of a qualified retirement or 403(a) plan and held until all amounts are distributed to the employee for whom the contract was purchased, or to the employee's beneficiary; or

5. is an immediate annuity.

Section 72(u) does not prohibit ownership of annuity contracts by corporations and other entities; it simply denies such entities the benefit of tax deferral. The changes to section 72(u) were effective with respect to contributions to annuity contracts after February 28, 1986. Thus, pre-March 1, 1986 annuity contracts to which no later contributions were made are, in effect, grandfathered. If contributions are made to a

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[2] H.R. Rep. No. 99-426, at 703 (1986).
[3] See PLR 200018046.
[4] See PLR 200720004.

pre-March 1, 1986 contract, section 72(u) would apply to the later contributions, although the application of the rule to such contracts is uncertain. For this reason, most tax advisors cautioned against making a post February 28, 1986 contribution to a pre March 1, 1986 contract.

The legislative history suggests that unless a contract meets one of the above exceptions, it is unlikely a corporation can be deemed to be acting as an agent for a natural person. The same would appear to be true of ownership by a partnership,[5] LLC or S corporation, despite the fact that these are all generally "flow-through" entities for income tax purposes.

In contrast, it is far more likely that a trust could be deemed to be the nominal owner of an annuity contract given the nature of the relationship between trust beneficiaries and the property held in trust, i.e., the beneficiaries are the beneficial owners of the property held in trust, the trustee merely holds legal title. In many instances, this relationship would support an argument that a trustee's ownership is nominal and that the contract should consequently be treated as held by a natural person.

In a series of private letter rulings dating from 1989, the Internal Revenue Service has been called upon to rule whether a trustee's ownership of an annuity contract was nominal or not. These rulings were presumably requested because purchasing an annuity contract within an irrevocable non-grantor trust can be beneficial, as it would allow the deferral of income that would otherwise be subject to the compressed tax brackets applicable to trust income. In 2013, for example, trust income in excess of $11,950 is subject to the maximum federal income tax rate of 39.6%.[6] In a trust not designed to provide current income to the beneficiaries, the ability to invest in an annuity contract and allow earnings to accumulate on a tax-deferred basis could be quite advantageous. Unfortunately, the fact that IRS guidance has come only in the form of private letter rulings means there is no authority upon which taxpayers can rely. The early rulings suggested that for a trust-owned annuity to be deemed to be held by a natural person, there could only be one trust beneficiary. The most recent ruling indicates that a multiple beneficiary trust can likewise qualify. A review of the rulings offers an insight into the Service's view of the breadth of the exception.

Ownership by a Grantor Trust

The grantor trust rules of IRC sections 671 through 678 cause the grantor of a trust to be treated as the owner of trust assets for income tax purposes and require trust income to be reported on the grantor's income tax return. If a grantor trust were to own an annuity contract, the grantor would be treated as owning the contract for income tax purposes, and it would seem to follow that the grantor would be treated as the owner for purposes of the non-natural person rule. This would seem particularly true if the grantor trust was a revocable living trust, since the grantor would have a retained power to

[5] See Internal Legal memorandum 199944020 in which the Service determined that the partnership was not acting as an agent for a natural person when the annuity in question was an asset of the partnership.
[6] See Revenue Procedure 2013-15, 2013-5 IRB 444 2828 January 2013).

terminate the trust and reacquire title to all assets. But if the grantor trust is an irrevocable trust, application of the rule is less clear because although the grantor would be treated as the owner for income tax purposes, he or she would normally not have any retained right to income or principal and would have no beneficial interest in any trust asset, including the annuity contract. Under these circumstances, it is not clear that the trust's status as a grantor trust, in and of itself, is sufficient to cause the annuity contract to be deemed to be held by a natural person. It may be necessary to look to the trust beneficiaries for this purpose.

Of the rulings that have been issued relating to trust-owned annuity contracts, three have involved grantor trusts. In two of these[7], the trusts were so-called "secular" trusts created by employees for the purpose of receiving and investing bonuses paid by the employer. The employees could elect to have the bonused amounts paid directly to them or to the trustee, and, in one of the cases; the employee was able to direct the investment of trust funds. In both instances it was intended that the trustees would invest in annuity contracts. In neither ruling did the employer have any interest in the trusts—the employees alone were entitled to all the benefits.

The Service noted in each case that the employee would be considered the owner of the trust because he or she would receive the economic benefit of the amounts paid by the employer to the employee's trust. Moreover, since the entire income of the trust would be distributed to the employee, or accumulated for future distribution to him or her, the employee would be treated as the owner of the trust under section 677 of the Code. Consequently, the Service concluded that an annuity contract held by the trust would be deemed held by a natural person.

The third ruling involved a trust created to pre-fund funeral expenses.[8] Under the arrangement, the grantor would make an irrevocable contribution to a trust of which he would be the beneficiary, and the trustee would invest the trust funds in an annuity contract or contracts. Upon the death of the grantor, the proceeds of the contract would be distributed to provide a casket and burial services for the grantor. Since state law imposed an obligation on the estate to pay for the grantor's funeral, the Service determined that the payment of the grantor's burial expenses pursuant to the terms of the arrangement constituted a reversionary interest in the trust property. Consequently, the grantor would be treated as the owner of both the corpus and income of the trust, and, if the contract(s) otherwise qualify as annuity contract(s) for purposes of section 72 of the Code, the contract or contracts held by the trust would be deemed to be held by a natural person for purposes of section 72(u).

In all three of these rulings, the grantor of the trust held a beneficial interest in the trust. In the first two, the grantor was to receive all of the trust income and corpus, and in the third ruling, the grantor's estate would receive the benefit. Although the result in these rulings appears correct, it is necessary to ask whether the result would have been the same if the grantors had held no beneficial interest in the trusts.

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[7] Priv. Ltr. Rul. 9316018; Priv. Ltr. Rul. 9322011.
[8] Priv. Ltr. Rul. 9120024

Ownership by a Trust with One Beneficiary

Another pair of early rulings involved the acquisition of an annuity contract by the trustee of a trust created for the benefit of one individual, apparently a child of the grantors.[9] Under the terms of the trust, the trustee had discretion to pay income and corpus to the beneficiary until age 40, at which point the entire trust corpus was to be distributed to the beneficiary. (The ruling was silent with respect to the disposition of trust corpus in the event the beneficiary died before attaining age 40.) The Service reviewed the legislative history of section 72(u) and simply concluded that although the trustee was the owner of the annuity contract, the trustee's ownership was nominal compared to that of the beneficiary and consequently, the beneficiary was the beneficial owner of the annuity contract.

Because the ruling failed to describe how the trust assets would be distributed in the event the beneficiary died before attaining age 40, it is not known whether any other person held an interest in the trust, as a contingent remainderman, and what bearing this may have had on the holding. For example, if the trust provided that the corpus would be paid to the beneficiary's estate, or if it were subject to a testamentary general power of appointment exercisable by the beneficiary, the ruling could be viewed as standing for the proposition that a trust's ownership of an annuity contract will be deemed nominal as long as all interests in the trust are held by one beneficiary. On the other hand, if the trust provided that corpus would pass to another person upon the death of the beneficiary, the ruling may mean that two persons can have an interest in a trust, and the trust's ownership of an annuity will still be deemed nominal. But must that interest be a contingent remainder interest, or can it be a vested remainder interest? Stated differently, would the holding have been the same if the beneficiary had held only a life income interest, and no right to receive principal?

In a series of rulings with almost identical facts,[10] the Service determined that a trust was acting as an agent for a natural person when it purchased an annuity contract for the sole benefit of the settlor's grandchild. The terms of the trust provided for the distribution of a portion of the trust when the beneficiary attained ages 30, 35 and 40. If the beneficiary failed to request a distribution upon the attainment of an age for which a distribution is permitted, then the trustee is directed to distribute that amount to a separate trust for the sole benefit of the beneficiary. All distributions to either the beneficiary or the separate trust will be in the form of an annuity contract. In addition, if the beneficiary dies before attaining the age at which the trust is set to terminate, the annuity contract will be paid to the beneficiary's issue or if there is no issue then to or for the benefit of those related to the beneficiary.

This ruling did not address what the tax consequences would be under §72 if any distribution from the trust was in the form of cash. An in depth discussion of the tax

[9] Priv. Ltr. Rul. 9204010 and 9204014
[10] Priv. Ltr. Ruls. 200449011, 200449013, 200449014, 200440015, 200449016 and 200449017

issues pertaining to a distribution from a trust owned annuity can be found below in the section of the article entitled “Application of the Penalty for Premature Distributions.”

Ownership by a Charitable Remainder Trust

The Service has issued only one ruling in which it determined that an annuity contract held in trust was not held as an agent for a natural person. In that ruling, the trust in question was a charitable remainder trust, under which the remainder interest was held by a charitable organization, and the unitrust interest was held by two grantors, who were natural persons.[11] The ruling cited the language of section 72(u) and with no discussion simply stated that the trust would be required to include in its ordinary income the income on the annuity contract because the trust “ . . . will not hold the annuity contract as ‘an agent for a natural person’ within the meaning of section 72(u)(1).”

Given the absence of any discussion, it is impossible to determine the basis for the Service’s conclusion and the relative weight to be afforded the fact that (1) there were two beneficiaries of the unitrust rather than one, and (2) the remainder interest was to pass to a non-natural person. With respect to the former, the relevant question, as noted above, is whether the language of section 72(u), relative to ownership as an agent for “a” natural person, is to be read literally, such that a trust with more than one beneficiary would not qualify. With respect to the latter, although natural persons held the unitrust interest, was the fact that the remainder interest was held by a non-natural person the controlling factor? And, as also noted, if that remainder interest had been contingent, rather than vested, would the result have been different? Although not conclusive, a 1997 ruling sheds some additional light on these questions.

Ownership by a Trust with Multiple Beneficiaries

In September of 1997, the Service issued a private letter ruling, which involved the acquisition of an annuity contract by a testamentary trust.[12] The trust was to be divided into separate shares for each remainderman, but the income from all shares was to be paid to the life income beneficiary. The trustees were given the power to distribute corpus to or for the benefit of the life beneficiary, the remaindermen, or the heirs of the remaindermen, under an ascertainable standard. The trustee intended to invest in an annuity contract which was to remain in deferred status until a future date specified in the contract, at which point a number of settlement options would be available. The life beneficiary was the annuitant.

The Service cited the language of section 72(u) and its legislative history and, as it had done in prior rulings, with no discussion, stated that although the trust was the owner of the contract, “. . . its ownership interest is nominal compared to Life Beneficiary and Remaindermen.” Accordingly, the Service ruled that the contract was held by a natural person for purposes of section 72(u)(1) of the Code.

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[11] Priv. Ltr. Rul. 9009047

[12] Priv. Ltr. Rul. 9752035.

Although the outcome of the ruling was favorable, the absence of any discussion leaves many unanswered questions. It is uncertain, for example, if the ruling should be read to mean that as long as all interests in a trust are held by natural persons, any annuity contract owned by a trust will be deemed to be held by a natural person. Assuming this is too broad a reading, then under what circumstances will a trust's ownership be considered more than "nominal"? Will a trust's ownership be deemed nominal if the trustee has complete discretion with respect to making or withholding of distributions of income and principal to the beneficiaries? Must all beneficiaries be identified, and must their interests be vested?

The Service issued another ruling[13] in which a trustee was directed to make a nominal distribution to one beneficiary and given discretion to distribute income to another beneficiary. The trust was primarily for the benefit of the three remaindermen and trustee stated that the three individuals were natural persons as the term was used in section 72(u). The trustee proposed purchasing three annuity contracts in which each remainderman was named as the annuitant of one of the contracts. At the termination of the trust, the annuity contracts will be distributed to the named annuitants and the trustee further stated that at no time would the trust distribute the contracts to anyone other than the three remainderman. Based upon the facts presented in the ruling request the Service determined that the annuity contracts are considered owned by natural persons for purposes of §72(u)(1). In addition, the IRS provided that the distribution of the annuity contracts to the remaindermen would not be considered a gratuitous transfer under section 72(e)(4)(C).

III. IMPACT ON OTHER PROVISIONS OF SECTION 72

Keeping in mind that private letter rulings carry no precedential weight, the rulings described above suggest that an annuity contract acquired within most inter vivos or testamentary irrevocable trusts can provide tax deferral. It is, however, important to consider the impact that other provisions of section 72 would have on such arrangements.

Distributions Upon the Death of the Holder of an Annuity Contract

Section 72(s) sets forth the required distribution rules, which an annuity contract must satisfy upon the death of the holder of an annuity contract. Specifically, it provides that if the holder of the contract dies on or after the annuity starting date and before the entire interest has been distributed, the remaining interest will continue to be distributed at least as rapidly as the method of distribution being used at the time of death. In addition, if the holder of the contract dies before the annuity starting date, the entire interest must be distributed within five years of the date of death. An exception to this general rule allows a designated beneficiary, within one year of the holder's date of death, to take

[13] Private Letter Ruling 199905015.

distribution of the proceeds over his or her life, or over a period not to exceed life expectancy. (A designated beneficiary is any individual designated as a beneficiary by the holder of the contract.) Moreover, if the holder's surviving spouse is the sole designated beneficiary, the surviving spouse has the ability to continue the decedent's contract as though it were his or her own.

The application to distributions upon the death of the holder before the annuity starting date is complicated by the fact that the "holder," that is, the trust, cannot be said to die. Section 72(s)(6) provides, however, that where the holder of an annuity contract is a corporation or other non-individual, the "primary annuitant" shall be treated as the holder for purposes of applying the distribution rules. The term "primary annuitant" is defined as the individual whose life is of primary importance in determining the timing or amount of the payout under the contract.

In general, if a trust owns a deferred annuity contract, it is the death of the annuitant that triggers the after-death distribution requirement pursuant to section 72(s)(6). Since the trust would (normally) be the beneficiary of the contract, the distribution would be made in accordance with the general rule that all amounts must be distributed within five years of death. Since a designated beneficiary must be an individual, the exception to the five-year rule that allows distribution to be made over the life expectancy of a designated beneficiary would appear inapplicable. In contrast, the final regulations under section 401(a)(9), which govern required minimum distributions from qualified plans and IRAs, provide that so long as certain requirements are met, it may be possible to look through the trust and take distributions based upon the life expectancy of the oldest trust beneficiary. A similar exception for amounts received from a non-qualified annuity contract has never been authorized.

If a trust is a grantor trust, and the grantor and the primary annuitant are not the same person, the relevant question is whether the grantor, rather than the primary annuitant, should be treated as the holder for purposes of applying the distribution rules of section 72(s). If the grantor were treated as the holder, then it would be the grantor's death, rather than that of the primary annuitant, that would determine when distribution from the contract would be made. Due to the uncertainty, some annuity providers require the grantor of a grantor trust and the annuitant to be the same individual. Where the grantor and annuitant are not the same individual, some providers may require the after-death required distributions to commence at the death of either the grantor or the annuitant, whichever occurs first.

Application of the Penalty for Premature Distributions

IRC Section 72(q)(1) imposes a 10 percent penalty tax on premature distributions from annuity contracts. The penalty is imposed on ". . . any taxpayer [who] receives any amount under an annuity contract . . ." and is levied on the portion of the amount received that is includible in the taxpayer's gross income. Section 72(q)(2) provides that the penalty shall not apply to certain distributions, including any distribution " . . . made

on or after the date on which the taxpayer attains age 59 ½, [or] . . . made on or after the death of the holder (or where the holder is not an individual, the death of the primary annuitant . . ."

If an annuity contract is owned by a non-grantor trust as an agent for a natural person, it is not clear how the 10 percent penalty is to be applied to amounts received under the contract because of the difficulty of identifying the "taxpayer" for purposes of section 72(q)(2). For example, until a contract is annuitized, only the owner, or holder, is entitled to receive any amount under the contract. This would suggest that the holder is the "taxpayer" whose age is relevant for purposes of applying the penalty to amounts received prior to age 59 ½. If this were correct, all withdrawals from a trust-owned contract would be subject to the penalty since a trust has no age. On the other hand, if a contract is annuitized, and under the terms of the contract the annuitant is entitled to receive all distributions, it might be argued that the annuitant is the "taxpayer" referred to in the exception and that his or her age is determinative. In such a case, however, the terms of the contract would appear controlling, because if the annuitant is merely the measuring life, and the trust, as owner of the contract, is entitled to the distributions from the annuity contract, the annuitant's age may be irrelevant.

Since the primary annuitant is generally treated as the holder of a trust-owned annuity contract for purposes of requiring a distribution upon the death of the "holder", it might be argued that it is also appropriate to look to the primary annuitant for purposes of applying the age 59 ½ exception to the premature distribution penalty. Doing so would assure consistent treatment of amounts received under the contract during life and at death and would arguably provide no greater tax benefit than if the contract had been owned by the annuitant. However, unlike the exception for distributions upon death of the holder, the exception for distributions on or after the taxpayer reaches age 59 ½ does not provide that the annuitant will be used to determine whether the exception applies when the holder is not an individual. It would also allow the penalty to be circumvented by a trust with multiple beneficiaries, if at least one beneficiary were age 59 ½. If that beneficiary were named as the annuitant, the trustee would be able to withdraw unlimited amounts from the contract, free of penalty, despite the fact that the withdrawn amounts might then be distributed to beneficiaries under age 59 ½. It is questionable whether Congress would have intended such a result.

Assuming the annuitant's age is not the relevant measure, is it instead the age of the beneficiary or beneficiaries? If so, must all beneficiaries be over age 59 ½ for the penalty to be avoided? Unfortunately, each of these questions remains unanswered. To avoid these issues, consideration should be given to having the trustee distribute the annuity contract outright to the beneficiary before the time at which withdrawals are to begin. In contrast, the Service has previously indicated that if a grantor trust owns an annuity contract, the grantor is treated as the owner of the annuity for federal income tax purposes and, therefore, if the grantor has attained age 59 ½, the 10% federal income tax penalty will not apply.[14]

[14] See Info. Ltr. 2001-0121.

IV. PLANNING WITH TRUST-OWNED ANNUITIES

As previously noted, for income and estate planning purposes it is sometimes desirable for a trust to be the owner of an annuity contract. In such situations, the application of section 72(u) and other relevant subsections of section 72 will naturally determine the appropriateness of this strategy. The following discusses some common situations in which an annuity contract might be purchased or acquired by a trustee and explores the implications of doing so.

Ownership by a Minor's Trust

A parent or grandparent interested in making gifts to children or grandchildren will sometimes create a section 2503(c), or minor's trust, in order to receive and hold the transferred funds. Gifts to a 2503(c) trust will qualify for the annual gift tax exclusion despite the fact that the beneficiary has no present right to receive trust income or principal. However, upon the minor's attainment of age 21, he or she must be given the right for a limited period of time to demand distribution of the entire trust principal. In the event the beneficiary declines to exercise this right, the trust property can continue to be held in trust for the benefit of the beneficiary.

Based on the rulings discussed previously, it is most likely that such a trust would be deemed to hold a deferred annuity contract as an agent for a natural person for purposes of section 72(u). As a result, the purchase of the annuity contract would enable the income accruing within the contract to be deferred and would not be subject to the compressed income tax brackets applicable to trusts. As noted above, it is likely that the 10 percent penalty for premature distributions would apply to all amounts distributed. This factor must be carefully considered before the purchase is made. Assuming the annuity is intended for the long-term income needs of the beneficiary, rather than an intermediate-term need such as education funding, the purchase may be appropriate.

Ownership of an Annuity by a Charitable Remainder Trust

As previously noted, ownership of an annuity contract by a charitable remainder trust was the subject of a private letter ruling issued in 1989. The outcome of the ruling was favorable in that the Service ruled that the trust would qualify as a charitable remainder trust. (The fact that the annuity contract was deemed not held by a natural person, and therefore did not provide tax deferral, had no adverse impact because a charitable remainder trust is a tax-exempt entity and pays no income tax.) However, several years later, the Service began to express concern about the purchase of annuity contracts within charitable remainder unitrusts, specifically, within "net-income" and "net-income-with-make-up" charitable remainder trusts (NIMCRUTs). The Service was concerned about the trustee's ability to manipulate the income of the trust, and correspondingly, the income of the beneficiaries, through withdrawals from the annuity contract. In 1997, the Service announced that it would not issue advance rulings or determination letters with respect to the qualification of a trust as a charitable remainder trust if the unitrust

amount is calculated under the net-income or net-income-with-make-up method and a grantor, trustee, beneficiary or person related or subordinate to the grantor, trustee or beneficiary can control the timing of the trust's receipt of income from a partnership or deferred annuity contract.

The Service's attention had been drawn to the increased use of charitable remainder trusts as a source of supplemental retirement income, primarily by individuals whose retirement plan contributions were limited by the qualified plan rules. A net-income-with-make-up charitable remainder unitrust became a vehicle of choice because of its unique characteristics. Unlike a charitable remainder annuity trust, which must distribute the required payout each year regardless of the amount of trust income received, a net-income charitable remainder unitrust need only distribute the income actually earned. Moreover, the make-up provision would allow any shortfall to be made up in the future when the trust income exceeded the required payout amount.

A NIMCRUT can operate as a quasi-retirement plan if the trust assets are invested in a manner that will minimize income and emphasize growth during the grantor/beneficiary's working years and are then repositioned upon retirement to emphasize income. An annuity contract would appear to be an ideal asset to use for this purpose given the fact that as long as no distributions are taken from the contract, there would appear to be no income, and hence no required payout. Upon the beneficiary's retirement, the trustee could begin taking withdrawals from the contract, which would provide the trustee with income to be distributed to the beneficiary.

It is important to recognize that the "income" of a NIMCRUT is not income for tax purposes, but may be considered income for fiduciary accounting purposes. Whether a particular item is considered income or principal for these purposes depends on local law and on the provisions of the governing instrument. If the trust provisions are fundamentally different from local law, local law will control. This means that in some jurisdictions the income accruing within a trust-owned annuity contract could be treated as fiduciary income, which would require the trustee to make distributions of the income, up to the amount of the required payout. It appears, however, at least in those states that have adopted the Revised Uniform Income and Principal Act, that the trust will not be deemed to have any fiduciary income until the trustee actually withdraws funds from the annuity contract.

Despite its pronouncement that it would not rule on a NIMCRUT holding an annuity contract, early in 1998 the Service issued just such a technical advice memorandum.[15] The TAM addressed three questions: (1) whether the purchase of annuity contracts by the trustee was an act of self-dealing (since the annuitants were disqualified persons); (2) whether the purchase would jeopardize the trust's qualification as a charitable remainder unitrust; and (3) whether the trustee's right to withdraw from or surrender the annuity contracts would cause the trust to have "income" for unitrust purposes? The Service responded to all three questions in the negative, noting with respect to the third

[15] Tech. Adv. Mem. 9825001.

question that although the relevant state statute appeared ambiguous, the statute implied that a trust does not realize either income or principal until it actually receives possession of money or other property. More recently, in informal discussions, the IRS has indicated that despite the ruling, the area remains under study.

Although the purchase of an annuity within a NIMCRUT remains uncertain, it appears to have some promise in light of these recent developments. It must be kept in mind, however, that the strategy is not without its risks. The payout from a unitrust is based on the value of the trust as valued annually. If the trust assets decline in value, the required payout will decline as well. With a NIMCRUT, the payout is further limited by the amount of income actually generated. Thus, the character of the distribution from the annuity contract as trust income or corpus again becomes an issue in determining whether distributions attributable to capital gains earned within the contract can be distributed to the beneficiary. If any part of a distribution is deemed to consist of capital gains, that part can only be paid to the beneficiary if local law or the trust instrument defines capital gains as fiduciary income.

Credit Shelter Trust as Beneficiary of an Annuity Contract

The foregoing discussion has focused exclusively on a trust as the owner of an annuity contract. There is, however, a common circumstance in which a trust is considered a potential beneficiary of an annuity contract. The following briefly discusses the considerations involved in naming a credit shelter trust as the beneficiary of an annuity contract.

A credit shelter trust is commonly incorporated into an estate plan in order to make use of the testator's unified credit upon death. The trust is typically designed to provide income to the surviving spouse for life and to pass to the children upon the spouse's death. In some instances, the testator may hold a substantial investment in annuity contracts and want to designate the credit shelter trust as the beneficiary in order to make full use of his or her unified credit. Doing so could have adverse tax implications.

From a planning perspective, an annuity contract is not an ideal asset to be used to fund a credit shelter trust for the simple reason that the contract will not obtain an increase in cost basis upon the death of the contract owner. As a consequence, the built-in income tax liability dilutes the benefit of the unified credit inasmuch as the decedent's heirs will not receive the portion attributable to the income tax. But, in addition to the general disadvantage of naming a credit shelter trust as the beneficiary, there are other factors, which must be considered.

As noted above, when a trust is named as the beneficiary of an annuity contract, it appears that the only distribution option available to the trustee is to receive the entire interest within five years of the death of the primary annuitant. In contrast, an individual designated beneficiary is able to take distribution over his or her life (or over any period not in excess of life expectancy) and thereby gain maximum benefit from the tax deferral provided by the contract. Moreover, if the sole designated beneficiary is the

spouse of the decedent, the contract can be continued in its deferred status. The trustee will have to take distribution no later than five years after death so that the entire deferred gain will be subject to income tax by the end of the five-year period. If the distributions were retained within the trust, the trustee would be responsible for the income tax rather than the beneficiaries. If they are paid out to the trust beneficiaries, a lower overall income tax may be payable on the distributions, but this may frustrate the objective of using the trust as an accumulation vehicle, or be inappropriate given the ages or situations of the beneficiaries. Therefore, it will be important to carefully weigh the estate tax benefits of funding the credit shelter trust with the annuity proceeds and thereby fully utilizing the unified credit at the first death against the income tax disadvantages of naming the trust as beneficiary.

V. CONCLUSION

Annuity contracts present special problems and raise special considerations when the owner or beneficiary is not a natural person. Although the law is intended to prevent corporations and other entities from enjoying the benefits of tax deferral, ownership of an annuity by a trust appears to permit tax-deferral in many situations. Yet, the only guidance that has been provided with respect to section 72(u) and the non-natural person rule has been through private letter rulings. What these rulings suggest is that ownership by a trust will generally provide tax-deferral when all of the beneficiaries are natural persons. However, until there is a more authoritative pronouncement issued by the Service, trust ownership of an annuity contract should be approached with appropriate caution.

Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele B. Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, and Barry Rabinovich. All comments or suggestions should be directed to tbarrett@metlife,com or jdonlon@metlife.com, Co-Editors.

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The federal tax rules impose certain requirements and limitations on annuity contracts. These rules may differ depending on whether an annuity contract is owned by an individual or non-natural person (e.g., trust or estate) and may also differ if a designated beneficiary is an individual or non-natural person. If a non-natural person, such as a trust, is the owner of a nonqualified contract, the distribution on death rules under the Internal Revenue Code may require payment to begin earlier than expected and may impact the usefulness of the living and/or death benefits. Naming a non-natural person, such as a trust or estate, as a beneficiary under the contract will generally eliminate the beneficiary's ability to stretch or a spousal beneficiary's ability to continue the contract and the living and/or death benefits. When purchasing an annuity contract, you should fully consider these rules and the impact these requirements and limitations may have on the contract and any living and/or death benefits provided under the contract.

Metropolitan Life Insurance Company
1095 Avenue of the Americas
New York, NY 10036

New England Life Insurance Company
501 Boylston Street
Boston, MA 02116

L0913342947(exp1015)(all states)(DC)

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The Transfer for Value Rule

Inside this issue

I. INTRODUCTION

In this issue of Legal & Tax Trends we take a close look at the transfer for value rule and its exceptions. First, we describe the transfer for value rule and focus on its application. Then we discuss the various exceptions to the rule and provide several examples for illustration purposes. Finally, we address special considerations for estate, business and employee benefit planning situations. We hope that you will find this information helpful as you face the challenges presented by the transfer for value rule. As always, your comments are invited.

Life insurance is an effective estate and business planning tool for many reasons. Perhaps, the most attractive aspect of life insurance is the income tax free receipt of the proceeds upon the insured's death. This income tax exclusion is applicable regardless of the type of policy, owner, premium payer, beneficiary or method of payment (e.g., lump sum or installment). However, there is an important provision of the Internal Revenue Code which, if applicable, could result in the loss of this favorable income tax treatment. This provision, referred to as the transfer for value rule, can be described as a tax trap that may cause some or all of the proceeds of a life insurance contract to be taxable as ordinary income to the beneficiary. Therefore, understanding the transfer for value rule and the exceptions to the rule are essential when restructuring existing life insurance contracts for estate, business and employee benefit planning purposes.

II. WHAT is a TRANSFER for VALUE?

The transfer for value rule of Code section 101(a)(2) states that: "In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income...{by the beneficiary under Code section 101(a)(1)} shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee."[1] So, if the transfer for value rule applies, life insurance proceeds in excess of the beneficiary's basis (i.e., amounts paid to acquire the policy plus subsequent premiums paid or other payments) would be taxable at ordinary income rates upon receipt. For example, Jack sells an insurance policy with a face amount of $50,000 to Steve for $10,000. Steve receives the $50,000 of proceeds upon Jack's death three years later. During the period in which Steve owned the policy, he paid premiums totaling $2,000. Steve can exclude the $10,000 purchase price plus the $2,000 of premiums that he subsequently paid from his gross income. The balance of $38,000 would be taxable as ordinary income. This is a sharp contrast from excluding the entire $50,000 of proceeds if the transfer had not violated the transfer for value rule.

III. APPLICATION of the TRANSFER for VALUE RULE

The application of the transfer for value rule hinges on the issue of whether a transfer for valuable consideration has occurred. However, the Internal Revenue Code does not specifically define the terms "transfer" or "valuable consideration" and the Regulations shed only some light on these definitions. According to the income tax regulations, a transfer for valuable consideration occurs whenever there is "... any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy." [2] However, specifically excluded from this definition is the pledge or assignment of a policy as collateral security (i.e., repayment of debt).[3] This definition does not require the physical transfer of policy ownership to invoke the rule.[4] For example, Ann is the owner and insured of a $75,000 insurance policy. John pays Ann $20,000 to be irrevocably named as the beneficiary of Ann's policy. Upon Ann's death, John can exclude $20,000 of the $75,000 of insurance proceeds. The $55,000 balance is taxable to John as ordinary income.

In addition to a transfer of a right to receive an interest in an insurance policy, the transfer must be for "value." Consideration must be provided for the transfer for value

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[1] See Rev. Rul.2009-25, IRB 2009-38. IRC §101(a)(1) provides the general rule for excluding death benefits from income. However, employer owned policies must satisfy the requirements of §101(j) for the proceeds to be received income tax free. A policy owned by a C Corporation may be subject to the alternative minimum tax even if the §101(j) requirements are satisfied.

[2] Treas. Reg. 1.101-1(b)(4).

[3] Id.

[4] Treas. Reg. 1.101-1(b)(1).

rule to apply.[5] Consideration is not limited to cash (i.e., an outright sale) or other property with an ascertainable value.[6]

Any consideration that is sufficient to support an enforceable contractual right to receive all or any part of the proceeds of an insurance policy is sufficient to create a transfer for value. For example, the mutual agreement to pay the premiums and to use the proceeds to purchase the insured's stock upon death resulted in the application of the transfer for value rule in both *Monroe v. Patterson,* 197 F. Supp. 146 (ND Ala. 1961) and Private Letter Ruling 7734048. Additionally, a transfer of a policy subject to a policy loan satisfies the consideration requirement based upon the theory that the transferor is being relieved of the loan obligation.[7]

IV. EXCEPTIONS to the TRANSFER for VALUE RULE

Fortunately, even though a transfer is determined to be for valuable consideration, the consequences may be avoided if one of the exceptions provided by Code Section 101(a)(2)(A) or (B) applies. The proceeds of an insurance policy will not lose the income tax free treatment, even though there has been a transfer for value, in the following situations:

1. A transfer to the insured;
2. A transfer to a partner of the insured;
3. A transfer to a partnership in which the insured is a partner;
4. A transfer to a corporation in which the insured is a shareholder or officer; or
5. A transfer in which the transferee's basis for determining gain or loss is determined in part by the basis of such contract in the hands of the transferor (e.g., gratuitous transfer).

Obviously, the identity of the transferee and the transferee's relationship to the insured is critical for an exception to the transfer for value rule to apply. Although in the majority of situations the insured is easily identified, there are two situations were the insured is not so apparent. For example, who is the insured for purposes of applying the transfer for value rule in a second-to-die or first-to-die life insurance contract? Private Letter Ruling 9542037 addressed the question of who is the insured in a second-to-die contract for purposes of a Code §1035 exchange, but the PLR did not answer this question for purposes of applying the transfer for value rule. The issue is also unresolved for a first-to-die policy. In light of the uncertainty in these situations, the rule may more easily be avoided if the transfer can be structured as a gratuitous transfer or if the transfer can fall within any one of the other recognized exceptions.

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[5] PLR 200826009 (June 27, 2008). The sale of membership interests in an LLC taxed as a partnership will not be considered a transfer for value under §101(a)(2).

[6] PLR 7734048 (May 26, 1977).

[7] Rev. Rul. 69-187, 1969-1, CB 45.

A Transfer to the Insured

A transfer of an insurance policy or interest therein to the insured, even though for valuable consideration, is an exception to the transfer for value rule. For example, ABC Corporation is the owner and beneficiary of a life insurance policy on John, a key executive. John is scheduled to retire from ABC Corporation at year-end. As part of John's retirement package, ABC Corporation assigns the ownership of this policy to John. The assignment of this policy results in a transfer for valuable consideration. Here, the consideration is based upon John's contractual right to receive the policy as part of his retirement benefits in exchange for services rendered as an employee. However, since the transfer was to John, the insured, the rule does not apply. Therefore, the death proceeds will be received income tax free by the beneficiary.

A Transfer in which the Transferee's Basis is Determined by Transferor's Basis

If a transferee's basis for determining gain or loss in an insurance policy is determined in whole or in part by the basis of such contract in the hands of the transferor, the rule does not apply to the transfer. Generally, these transfers fall into three categories: (i) gratuitous transfers for "love and affection;" (ii) transfers pursuant to a tax-free corporate reorganization or (iii) a sale from the grantor to his or her wholly owned grantor trust. For example: Marie gives a $200,000 insurance policy on her life to an irrevocable life insurance trust and files a gift tax return. The trust beneficiaries are Marie's children. Since the trust's (transferee's) basis in the policy is determined by Marie's (transferor's) basis in the policy, the transaction falls within the transferor's basis exception to the transfer for value rule. Furthermore, a gift, by definition, is not a transaction for valuable consideration. Thus, without valuable consideration, the consequences of the transfer for value rule are avoided.

A Transfer to a Corporation in which the Insured is either a Shareholder or Officer

Another exception to the transfer for value rule involves the transfer of a policy for valuable consideration to a corporation in which the insured is either a shareholder or officer. To qualify for this exception, the insured must be a shareholder or officer of the corporation, not just an employee. If the insured is a shareholder of the corporation, the number of shares owned by the shareholder is irrelevant.[8] If the insured is an officer, he/she must have executive level duties, responsibilities and authority. For example, Mark is a vice president of XYZ Corporation. Mark is the owner and insured of a $250,000 insurance policy that is no longer needed for estate planning purposes. XYZ Corporation is interested in acquiring an insurance policy on Mark's life to provide key person coverage. Mark sells the policy to XYZ Corporation to provide this coverage. The sale of this policy to XYZ Corporation results in a transfer for valuable consideration. However, the transfer to XYZ Corporation of which the insured (i.e., Mark) is an officer is an exception to the transfer for value rule. Therefore, the proceeds will not be income taxable to XYZ Corporation upon Mark's death.

[8] PLR 9054004 (July 31, 1990).

A Transfer to a Partnership in which the Insured is a Partner

A transfer of an insurance policy, even though for valuable consideration, to a partnership in which the insured is a partner is an exception to the transfer for value rule. A partnership is defined under the Uniform Partnership Act, §6(1), as "an association of two or more persons to carry on, as co-owners, a business for profit." The existence of a partnership is generally determined under federal and state law. For example, Ken and Cheryl own and operate several commercial buildings as a real estate partnership. The partnership meets all state and federal requirements as a bona fide business. To fund a redemption of her partnership interest upon her death, Cheryl sells a $500,000 insurance policy on her life to the partnership. The sale of this policy to the partnership results in a transfer for valuable consideration. However, the transfer to the partnership of which the insured (i.e., Cheryl) is a partner is an exception to the transfer for value rule. Therefore, the death proceeds will be received income tax-free by the partnership.

The key to taking advantage of this exception is the existence of a bona fide partnership (or a limited liability company which is treated as a partnership for tax purposes) with a legitimate business purpose. The life insurance policy does not need to be related or connected to the partnership under the Internal Revenue Code or the Regulations for the exception to apply.[9] For example, ABC Corporation owns a key person insurance policy on the life of Tom, the majority shareholder. Tom and two minority shareholders are also partners in an equipment leasing company, unrelated to ABC Corporation. In order to provide funding for a buy-sell agreement, the equipment leasing company purchases the policy on Tom's life from ABC Corporation. Although the equipment leasing partnership has no association with the purpose for which the key person insurance was obtained, the partnership exception to the transfer for value rule would apply.

A Transfer to a Partner of the Insured

Another exception to the transfer for value rule involves the transfer of a policy for valuable consideration to a partner of the insured. As previously discussed, the partnership of which the insured is a partner must be a valid partnership under both federal and state law. Therefore, in order to be applicable, each partner must have a legitimate share in a bona fide partnership.[10] The amount of interest owned by a partner is not a concern. For example, James owns a 98% interest in a limited liability company that is treated as a partnership for income tax purposes. Michael owns the remaining 2% interest. James is the owner of a $500,000 policy on his life. To fund a cross purchase agreement, James sells a $500,000 insurance policy he owns on his life to Michael. This sale results in a transfer for valuable consideration. However, the transfer to Michael, a partner of the insured (i.e., James) falls under an exception to the rule.

[9] See, e.g.,PLR 9235029 (May 29, 1992).
[10] PLR 9045004 (July 31, 1990).

Therefore, the proceeds payable to Michael will not be subject to income tax upon James' death.

A Series of Transfers For Valuable Consideration

Generally, once a transfer for value taints an insurance policy, the taint stays with the policy. However, even if there are a series of transfers that do not fall within the exceptions to the transfer for value rule, if the last transfer immediately preceding the insured's death is to an exempt party, the taint is removed. The exempt parties include the insured, a partner of the insured, a partnership in which the insured is a partner, and a corporation in which the insured is either a shareholder or officer.[11] For example, ABC Corporation purchases an insurance policy with a face amount of $100,000 on the life of Tom, a shareholder. ABC Corporation later sells this policy to Joseph, another shareholder, for $15,000 to fund a cross purchase agreement. During the time period that Joseph owns the policy; he pays a total of $2,000 of premiums. Joseph later sells the policy to XYZ Corporation of which Tom is an officer for $25,000 to provide key person coverage. XYZ Corporation receives the proceeds of $100,000 upon Tom's death. The entire $100,000 is excluded from the gross income of XYZ Corporation because the final transfer in the series was to a corporation of which the insured (i.e., Tom) is an officer.

If, however, the last transfer in the above example were from Joseph to his son for "love and affection" instead of to XYZ Corporation, Joseph's son could only exclude $17,000 (the $15,000 purchase price plus $2,000 of premiums paid) of the $100,000 of proceeds from his gross income. A gratuitous transfer is not an exempt transfer under these circumstances because the transferee stands in the shoes of the transferor. Therefore, because the transfer from ABC Corporation to Joseph did not fall under one of the exceptions to the transfer for rule, the taint stayed with the policy.

V. ESTATE PLANNING CONSIDERATIONS

The creation of an estate plan is governed by an individual's objectives, family circumstances and financial status. Over time, these goals and circumstances may change. If the purpose of or need for life insurance coverage changes, there is often a corresponding need to change the ownership and/or beneficiaries of the policy. However, the potentially disastrous consequences of violating the transfer for value rule dictate that caution must be exercised when modifying or transferring a life insurance policy.

Part-Sale/Part-Gift Situations

The part-sale/part-gift issue often occurs in an inter-family context in the following situations: (i) a sale of a policy for less than fair market value; and (ii) a gift of a policy

[11] Treas. Reg. 1.101-1(b)(3)(ii).

subject to a policy loan. The sale of an insurance policy, even if for less than fair market value, results in a transfer for valuable consideration. However, if such sale is to a family member, the transaction may be characterized as part-sale/part-gift and avoid any adverse consequences due to the carryover basis exception. For example, Mom owns a $50,000 insurance policy on her life that has a $5,000 cash value and a basis of $4,000. Mom sells this policy to her son for $1,000. Because the son's basis is the greater of Mom's basis or the amount paid, it is determined in whole or in part by his mother's basis, and the carryover basis exception applies. However, if the sale proceeds had exceeded the mother's basis, the carryover basis exception to the rule would not apply.

As previously discussed, the transfer of a policy encumbered by a policy loan is considered a transfer for valuable consideration.[12] Therefore, if such a policy is gifted to a family member, the transfer would constitute both a sale (i.e., assumption of loan obligation) and a gift. The basis of such policy in the hands of the transferee family member would be the greater of the assumed policy loan or the insured's basis at the time of transfer. If the insured's basis were greater than the policy loan, the transfer would be exempt under the transfer for value rule because the transferee's basis is determined in part by the transferor's basis in the contract. But, if the policy loan amount were to exceed the insured's basis, the transferee loses the protection of this exception to the rule. Therefore, prior to gifting an encumbered policy, both the outstanding loan amount and the transferor's basis should be carefully analyzed to avoid adverse results under the transfer for value rule. For example, Mom owns a $50,000 life insurance policy on her life in which she has paid $10,000 of premiums. The policy has $15,000 of gross cash values and a $12,000 policy loan. If Mom gifts the policy to her son, the son loses the protection of this exemption since the son's basis is no longer determined by the Mom's basis. Upon Mom's death the son would report ordinary income on the death benefit to the extent that it exceeded his basis (i.e., $12,000 plus any subsequent premiums paid by the son).

Irrevocable Life Insurance Trusts

Irrevocable trusts are an effective estate planning tool to own life insurance outside of an insured's taxable estate. However, after the passage of time, an insured's objectives or family situation may change. Thus, the trustee may wish to transfer the ownership of a life insurance policy which funds the irrevocable trust to another individual or entity. But, in addition to potential estate and gift tax consequences, transferring such a policy may result in a transfer for value problem. In order to avoid the income tax consequences of a transfer for value, careful attention should be given to the application of the rule and its exceptions.

For example, Brian is the trustee of an irrevocable life insurance trust that was executed five years ago. The trust is funded with a $500,000 insurance policy on the grantor's life. Three years ago, the grantor and his spouse gave birth to another child. To enable this child to share in the policy proceeds, the trustee, Brian, wished to transfer or sell the

[12] Rev. Rul. 67-187, 1969-1 CB 45.

policy to a newly created irrevocable trust that is held for the benefit of all of the grantor's children. If, as trustee, Brian were to transfer the policy without consideration to the new trust, he would violate his fiduciary obligation. Therefore, Brian must sell the policy to the new trust for its fair market value, resulting in a transfer for valuable consideration. Furthermore, under these facts, an exception to the rule does not apply. Thus, the proceeds will be income taxable to the trust when received. But, what if the newly created irrevocable trust was a grantor trust?

On February 16, 2007, the IRS issued a favorable revenue ruling on this subject giving authoritative guidance on the sale of a life insurance policy to a grantor trust. In general terms, the ruling states that a transfer for valuable consideration (a sale) of a life insurance policy to a grantor trust that is treated as wholly owned by the grantor for income tax purposes is not a "transfer for value" within the meaning of Section 101(a)(2)[13]. The ruling deals with two situations: (1) a sale of a life insurance policy on the life of the grantor by a grantor trust to a grantor trust and (2) a sale of a life insurance policy on the life of the grantor by a non-grantor trust to a grantor trust. In both situations, the IRS stated clearly that the transfer for value rule was avoided.

VI. BUSINESS SUCCESSION PLANNING CONSIDERATIONS

Transfer for value issues often arise when funding or restructuring business succession arrangements. Typically, either the corporation or the stockholder is the owner of an existing insurance policy that could fund the newly created buy-sell agreement. However, due to the possible income tax consequences from the application of the transfer for value rule, caution must be exercised when transferring life insurance policies in this context. It is essential that prior to transfer, the transaction be analyzed to determine if it violates the transfer for value rule and, if so, if an exception applies to avoid the income tax ramifications.

Stock Redemption and Cross Purchase Agreements

In certain circumstances, shareholders of a corporation may prefer to structure the business succession plan as a stock redemption. Generally, this may be the case when there are more than two or three shareholders because a stock redemption agreement limits the number of insurance policies necessary to fund the agreement. If there is an existing policy individually owned by an insured shareholder, this policy may be transferred to the corporation for valuable consideration and avoid the adverse income taxes because a transfer to the corporation of which the insured is a shareholder is an exception to the rule. This may also be accomplished if the agreement was initially a cross purchase agreement and funded with cross-owned insurance policies, provided that the insured is still a shareholder of the corporation. For example, Michele and Molly were equal shareholders in XYZ Corporation. Several years ago, Michele gifted a portion of her stock to her brother Michael. As a result the cross purchase agreement

[13] Revenue Ruling 2007-13, 2007-11 IRB (16 February 2007)

was changed to a stock redemption agreement. Michele sold the policy she owned on Molly's life to XYZ Corporation and Molly did the same. These transfers, although made for value, avoid the transfer for value rule because both Michele and Molly are shareholders of XYZ Corporation.

A transfer for value problem may arise when shareholders decide to change their buy-sell agreement from a stock redemption agreement to a cross purchase agreement. A cross purchase agreement may be preferable in some situations to avoid the corporate alternative minimum tax or to take advantage of a step-up in basis due to the purchase. If the corporation transfers a policy for value to a co-shareholder to fund the agreement, the policy proceeds may be income taxable if an exception to the transfer for value rule does not apply. For example, Michele, Molly and Michael each own stock in XYZ Corporation that is subject to a stock redemption agreement. The agreement is funded with corporate owned insurance policies on each shareholder's life. Later, after Michael's death, the remaining shareholders decide to terminate the redemption agreement. Michele and Molly then enter into a cross purchase agreement. To fund this agreement, XYZ Corporation sells the insurance policies to the respective co-shareholder. The transfer of each policy to a co-shareholder results in a transfer for valuable consideration. Additionally, under these facts, an exception to the rule does not apply, thus the proceeds to the extent such proceeds exceed the beneficiary's basis will be income taxable to the co-shareholder when received.[14]

Alternatively, if XYZ Corporation were to bonus these policies to Michele and Molly on a cross-owned basis, a transfer for value would still result because the transfer was made in exchange for services rendered. The shareholders would be required to include the death proceeds as ordinary income to the extent such proceeds exceed the shareholder's basis. But, what if Michele and Molly were also partners in a partnership that bought and managed commercial real estate? Here, the transfer of each policy to a co-shareholder, although for value, would fall under the partner of the insured exception to the rule. Thus, the proceeds would not be subject to income tax when received by the co-shareholder/partner.[15] Alternatively, what if, to take advantage of the partnership exception, Michele and Molly created a partnership just to own the policies? The ownership and management of life insurance policies as the sole business purpose of a partnership was addressed in Private Letter Ruling 9309021. In this ruling, the Service concluded that the partnership was still a partnership under state law even though the sole purpose was to own life insurance. However, as the Service has refused to provide any further rulings in this area and appears to be re-thinking its position, this ruling should not be relied upon.[16] Furthermore, private letter rulings are specific to the taxpayer requesting the ruling and may not be relied upon by any other taxpayer. Thus, it is recommended that all partnerships have a bona fide business purpose under state and federal law independent of the ownership and management of life insurance policies.

[14] See, e.g., PLR. 7734048 (May 26, 1977).
[15] See, e.g., PLR 9347016 (August 24, 1993).
[16] Rev. Proc. 98-3, 1978-1 IRB 100.

Trusteed Cross Purchase Agreements

As previously discussed, the major disadvantage to funding a multi-shareholder cross purchase agreement is the number of life insurance policies required. To avoid the use of multiple policies and the disadvantages of a stock redemption agreement, many stockholders choose to utilize a trusteed cross purchase agreement. This type of buy-sell arrangement is similar to a traditional cross purchase agreement except it makes use of a trustee (i.e., escrow agent) to hold title to the life insurance funding (and sometimes the stock as well). Although a trusteed cross purchase agreement appears to be the solution to the multiple policies funding issue, this type of arrangement *may* result in a transfer for value problem. For example, John, Henry and Patrick are shareholders of ABC Corporation. They have created and funded a trusteed cross purchase agreement. Henry dies shortly after the agreement has been finalized. At first blush, Henry's death does not appear to create a transfer for value problem. However, at the time of his death, Henry owned a 50% beneficial interest in the trust-owned policy insuring John's life and a 50% interest in the policy insuring Patrick's life. Thus, upon Henry's death, the "transfer" of these interests from Henry's estate to John and Patrick, as surviving shareholders, may result in a transfer for value. Therefore, unless all three stockholders are also partners in a bona fide partnership, the proceeds *could* be subject to income tax when received by the surviving shareholder.

The Service has not ruled on the potential transfer for value issues involved in a trusteed cross purchase agreement. Some practitioners argue that the transfer of a beneficial interest in a trust is not a transfer of any interest in an insurance policy as required by the Code. Therefore, without a transfer of a policy, how could there be a transfer for valuable consideration? Due to the uncertainty of the application of the transfer for value rule to trusteed cross purchase agreements, perhaps these agreements should only be utilized if the shareholders are also partners in a bona fide partnership to avoid any potential income tax consequences.

Endorsement Split Dollar Arrangements

An endorsement split dollar arrangement is often used to fund a cross purchase agreement when premium cost is an issue for the participating shareholders. For example, Daniel and Paul, as equal shareholders in XYZ Corporation, decide to enter into a cross purchase agreement. They wish to fund the agreement with life insurance. To provide a source of funding dollars, XYZ Corporation purchases the policies and under an endorsement split dollar agreement, endorses the amount of proceeds over XYZ's interest in the policies to the co-shareholders. Daniel and Paul recognize income annually as required under the arrangement. Because this endorsement split dollar arrangement was established from the date of issuance and the third party endorsee actually signed the policy application, we feel that there is no transfer of any interest in an insurance policy as required by the Code. Therefore, without a transfer of a policy, there is no transfer for valuable consideration. However, if an existing policy were used to fund the endorsement split dollar arrangement, the Service could argue that a transfer for valuable consideration has occurred. But, if the shareholders are also

partners in a bona fide partnership, the consequences of the transfer for value rule could be avoided.

Family-Owned Business Issues

A transfer for value issue may also arise in a family business setting. Often, as younger family members age and demonstrate capabilities, older family members become interested in developing a business succession agreement. This agreement may incorporate using existing life insurance policies owned by the older generation or the family-owned business to fund a cross purchase agreement. The type of situation was addressed in PLR 8906035. In this ruling, a father and son implemented a cross purchase agreement to provide for a smooth transfer of ownership upon the father's death. Under the agreement, the corporation sold an insurance policy on the father's life to the father.

The father then transferred the policy to his son. Here, the Service held that both the transfer from the corporation to the insured and the gratuitous transfer by the father to the son were exempt from the transfer for value rule. However, it does not appear from the ruling that the Service considered the potential consideration provided by the son through his contractual obligation to purchase his father's stock. Thus, a more conservative approach would be to avoid using such policies in these situations unless another exception to the transfer for value rule applies.

VII. EMPLOYEE BENEFIT PLANNING CONSIDERATIONS

The application of the transfer for value rule arises in two primary areas of employee benefit planning: (i) transfers to and from a qualified plan; and (ii) transfers from a corporation to an employee.

Transfers to or from a Qualified Plan

The application of the transfer for value rule to the transfer of life insurance policies to or from a qualified plan has been addressed by the Service in several rulings.[17] Overall, the general rule established by these rulings is that if the purchase by or from a retirement plan does not represent a "significant change in beneficial ownership," the transfer will not violate the transfer for value rule. Additionally, a contribution of a policy to a qualified plan if made by the employer on behalf of the participant or voluntarily by the employee participant also avoids the transfer for value rule, provided there has been no significant change in beneficial ownership.[18]

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[17] See, e.g., PLR 9109018 (Nov. 29, 1990); PLR 7848068 (August 31, 1978); and PLR 8430102 (April 27, 1984).

[18] Rev. Rul. 74-76, 1974-1 CB 30.

Transfers by a Corporation to an Employee

Occasionally, a corporation chooses to transfer a corporate-owned life insurance policy insuring the life of an executive or key employee to such individual upon retirement. If the transfer is from the corporation to the insured, the transfer will avoid the application of the transfer for value rule since the transfer is to the insured. However, if the transfer is to a beneficiary chosen by the employee (e.g., spouse or irrevocable trust), and this beneficiary is not a partner of the employee, all or part of the proceeds would be taxable as ordinary income. For example, ABC Corporation is the owner and beneficiary of an insurance policy on the life of John, a key executive. John is scheduled to retire from ABC Corporation at year end. As part of John's retirement package, ABC Corporation assigns the ownership of this policy to an irrevocable insurance trust created by John. The assignment of this policy would appear to result in a transfer for valuable consideration, and because an exception would not apply, all or part of the proceeds will be income taxable to the trust upon John's death. The better approach would be for ABC Corporation to transfer the policy to John. Then after a reasonable period of time, John could have gifted the policy to the trust. The major disadvantage of this option is that if John's death were to occur within three years of the date of the gift to the trust, the policy proceeds would be included in John's taxable estate. Nevertheless, as long as John lives for three years after the transfer, the proceeds would be received income and estate tax-free. In contrast, the taint created by the direct transfer of the policy to the trust will never be removed.

VIII. CONCLUSION

Life insurance is an integral component of most estate, business and employee benefit planning situations due to the favorable income tax treatment it receives. However, the income tax-free nature of death benefits may be lost if the transfer for value rule has been violated. The penalty for violating this rule results in all or a portion of the policy death proceeds being taxable as ordinary income to the beneficiary. The harsh tax treatment for violating the transfer for value rule highlights the importance of conferring with independent tax and legal counsel.

Generally, the development and implementation of an estate and/or business continuation plan occurs over a period of time. During this evolution, the need to modify or transfer existing life insurance policies may arise. To maintain the income tax benefits for the beneficiary, the possible application of the transfer for value rule must be addressed prior to any transfer. However, the many exceptions to the rule provide viable planning alternatives to preserve the tax-free nature of the death proceeds even if the policy is transferred for valuable consideration.

Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, and Barry Rabinovich. All comments or suggestions should be directed to tbarrett@metlife,com or jdonlon@metlife.com, Co-Editors.

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1035 Exchanges

Inside This Issue:

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1. Introduction

The number and variety of life insurance and annuity products available to the public speak to the popularity such products enjoy and to their importance in providing a secure financial future for their owners. However, even clients who fully appreciate the value that such products provide may find themselves in circumstances where the specific policy or annuity contract does not suit their needs, as would a similar product with different features. Given the constant evolution of rights and benefits available in the marketplace, it is safe to say that one will always be interested in owning the product most appropriate for their current and expected future needs. It also hardly requires mention that changing products without recognizing a tax will be the preferred method, when possible.

Congress recognized this desire when it enacted Internal Revenue Code (IRC) §1035.[1] This IRC section codifies the belief that policyholders should not be treated as having surrendered or sold their contracts when the differences between the new and old contracts are not material. The House Committee Report in 1954 indicates that §1035 was designed to eliminate the taxation of individuals "who merely exchanged one insurance policy for another better suited to their needs but who have actually recognized no gain."[2] This document will explore the elements of §1035 to give the reader a better understanding of how exchanges of life insurance products are taxed for federal tax purposes and which transactions will qualify for tax-free exchange treatment.[3]

[1] All references to IRC section numbers (§) refer to the Internal Revenue Code of 1986 unless otherwise noted.

[2] H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 81 (1954). In this respect, §1035 serves as the insurance analogue to the like-kind exchange rules established in IRC §1031 for exchanges of investment and trade or business property.

[3] Please note that while certain exchanges may qualify for non-recognition for federal income tax purposes, state law may nevertheless require recognition of gain for state income tax purposes

2. The Code and Regulations

Absent §1035 qualification, the surrender of one policy and the purchase of another with the sale proceeds would result in income under the cost recovery rule equal to the cash surrender proceeds in excess of the owner's basis in the old policy. That is, a policyholder will recognize as ordinary income any gain in an exchanged contract, just as if the original policy had been surrendered or bought for cash. To effect Congress' intent to extend non-recognition treatment to certain exchanges, IRC §1035(a) provides:

> *No gain or loss shall be recognized on the exchange of –*
>
> *(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract or for a qualified long-term care insurance contract; or*
> *(2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract, or (C) for a qualified long-term care insurance contract;*
> *(3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or*
> *(4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.*

Treasury Regulation §1.1035-1 clarifies the exchange rules under section 1035(a)(3) by providing that:

> *Section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract. This section and section 1035 do not apply to transactions involving the exchange of an endowment contract or annuity contract for a life insurance contract, nor an annuity contract for an endowment contract. In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section 1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031(b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035(a) shall be governed by section 1031(d) and the regulations thereunder.*[4]

While the general rules are relatively straightforward, Treasury Department determinations and case law have refined the standards by which exchanges will be measured.[5] This article will examine these developments in depth.

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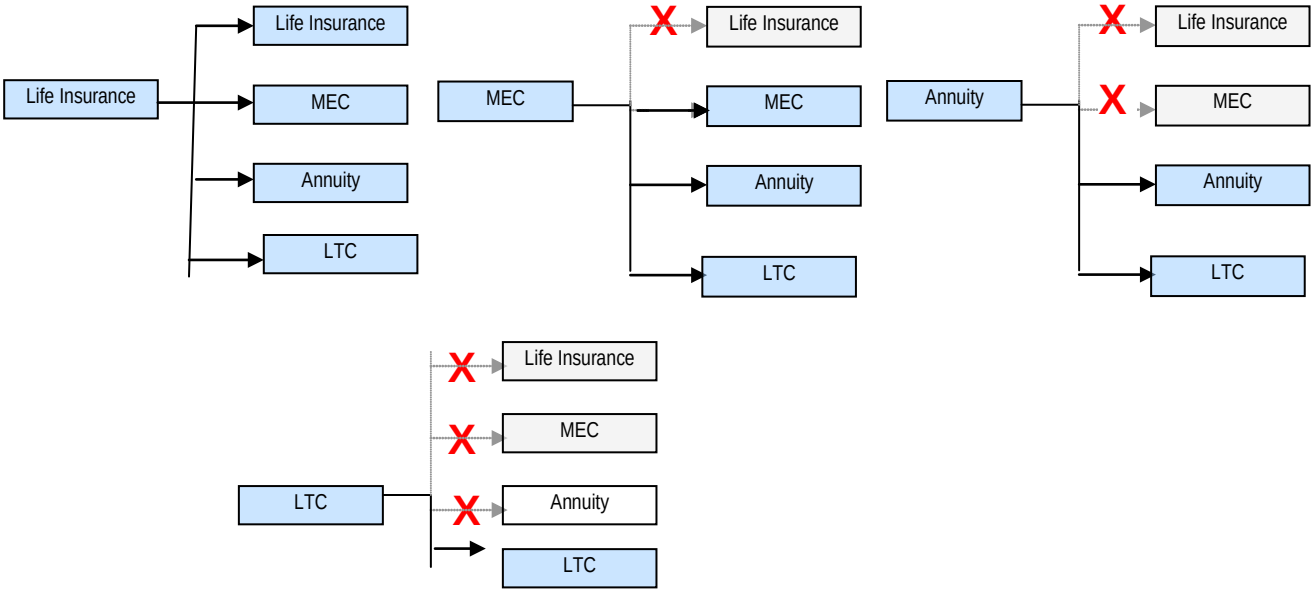
[4] §1031 outlines the conditions under which gain (or loss) from an exchange of property held for productive use or investment will not be recognized. This section applies, for example, to like-kind exchanges of real estate.

[5] The instructions for IRS Form 1099-R currently restate the basic requirements of §1035:
Section 1035 exchange. A tax-free section 1035 exchange is the exchange of (a) a life insurance contract for another life insurance contract, or for an endowment, or annuity contract, or for a qualified long-term care contract; or (b) an endowment contract for an annuity contract; qualified long-term care contract or for another endowment contract that provides for regular payments to begin no later than they would have begun under the old contract; or(c) an annuity contract for another annuity contract or qualified long-term care contract; or (d) a qualified long-term care insurance contract for a qualified long-term care insurance contract . However the distribution of other property or the cancellation of a contract loan at the time of the exchange may be taxable and reportable on a separate 1099-R.

3. Types and Number of Policies

While a life insurance contract may be exchanged tax-free for another life insurance contract, a modified endowment contract (MEC), an annuity, or a qualified long-term care contract,[6] the reverse is not true. An endowment contract may be exchanged tax-free for another endowment contract, an annuity or a qualified long-term care contract, but not for a life insurance contract.[7] An annuity contract may be exchanged for another annuity or a qualified long-term care contract, not for an insurance policy or endowment contract.[8] Finally, a long term care policy can only be exchange for another long term care policy.



A contract shall not fail to be treated as an annuity contract or as a life insurance contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

VUL vs. UL vs. WL: The IRC does not distinguish between types of permanent contracts for §1035 purposes. Therefore, a variable universal life (VUL) policy may be exchanged tax-free for whole life or universal life, and vice versa. For example, in Rev. Rul. 68-235 a taxpayer exchanged a life insurance contract, an endowment contract, and a fixed annuity (prior to maturity) for three variable annuity policies.[9] Similarly, a new contract may have a different guaranteed investment rate than the original contract.[10]

Presumably these instructions will be amended to conform to the new law applicable to exchanges made after December 31, 2009.

[6] While such exchanges are permitted under the Code, some insurance carriers may have restrictions on certain exchanges. For example, not permitting the exchange of a life policy into an annuity if the life policy has more than a 5% surrender charge.

[7] See also Rev. Rul. 54-264, 1954-2 CB 57, and *Barrett v. Comm.*, 16AFTR 2d 5380 (1st Cir. 1965) *aff'g* 42 TC 993.

[8] See PLR 8905004, in which the taxpayer exchanged an annuity contract for a life insurance policy and an annuity. The insurance policy was treated as boot, so that while the "annuity for annuity" portion of the transaction qualified for §1035 non-recognition treatment, the taxpayer recognized gain to the extent of the value placed in the insurance contract.

[9] Rev. Rul. 68-235, 1968-1 CB 360.

[10] PLR 8442010 (July 3, 1984).

Term Conversions: Term conversions do not qualify for §1035 treatment. In a term conversion, the new (permanent) policy results from the exercise of a right under the old (term) policy, not from an exchange for it. As a result, the owner's basis in the new policy does not carry over from the old policy. While the IRS has not opined on the subject, some commentators believe the transfer of existing cash values into a new policy created under a term conversion right should qualify. Clients should consult with their tax advisors for guidance on the viability of such a transaction.[11]

Different Insurers: Exchanges may involve contracts issued by one or more insurers. As stated by the IRS, "there is no requirement … that the issuer of the contract received in exchange be the same as the issuer of the original contract."[12] For example, an "internal exchange" of one contract for another where both are from the same issuing company will qualify, as will an "external exchange" of one contract from one insurer for another contract from a different insurer. Private Letter Ruling 9319024 provides that non-recognition treatment pertains even if one or the other of the insurers is a foreign company, as long as the product(s) meet the statutory definitions of life insurance, annuity, and endowment contracts.[13]

Multiple Contracts: Just as §1031 applies to exchanges of multiple properties, §1035 applies to exchanges of multiple life insurance and annuity contracts. The basis for this conclusion rests in IRC §7701(m)(1), which cross-references Title 1 of the United States Code, which in turn provides that "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise, words importing the singular include and apply to several persons, parties, and things." The following exchanges (a nonexclusive list) qualify for §1035 non-recognition treatment:

- Two insurance policies (on the same life) for one insurance policy.
- Two life insurance contracts for one new annuity contract,[14]
- Consolidation of two existing annuities into one.[15]
- One annuity contract for two annuity contracts.[16]

The listed transactions represent examples provided in private letter rulings from the IRS. Other combinations of contracts may be acceptable (e.g., three life insurance contracts for one new life contract), but have not been addressed specifically. While these transactions are permissible under the code one should check with their individual carrier to confirm they are permissible with that company.

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[11] The question of whether a term policy may be exchanged for a permanent policy has not been addressed by the IRS in a published ruling, likely because there is little incentive to avoid gain recognition in a policy (i.e., the term policy) which does not have a surrender value.

[12] PLR 73-124, 1973-1 CB 200.

[13] Please note that certain outbound exchanges may result in recognition. §1035(c) provides:

> *To the extent provided in regulations, subsection (a) [non-recognition] shall not apply to any exchange having the effect of transferring property to any person other than a United States person.*

[14] See PLR 9708016 and PLR 9820018. The taxpayer received no money or other property in the transaction.

[15] Rev. Rul. 2002-75, 2002-45 IRB 812 (2002). The taxpayer's basis in the new annuity will equal his combined basis in both consolidated contracts. In this ruling, the taxpayer consolidated the two existing annuities into one – there was no new annuity issued as part of the transaction.

[16] See PLRs 200243047 and 9644016

4. Same Insured Requirement

Treasury Regulation §1.1035-1 provides that §1035 does not apply if the policies exchanged do not relate to the same insured. For life insurance policies and endowment contracts both the existing policy and the new policy must be issued on the life of the same insured(s); presumably this is the case with long term care policies. For an annuity exchange, the obligee under both contracts must be the same person(s).[17]

The "same insured rule" of §1035 supersedes any rights granted under the policy. Thus, for example, the substitution of insureds under a corporate-owned policy will not qualify for tax-free exchange treatment, notwithstanding the policy option giving the corporation the right to substitute insureds.[18] Absent such a rule, policyholders would be able to effectively defer gain on a policy indefinitely, by changing to a younger insured from time to time.

Single Life to Survivorship: The same insured requirement prevents most exchanges involving single life and joint life policies from qualifying for non-recognition. Private Letter Ruling 9542087 held that certain exchanges involving second-to-die policies do not qualify for §1035 because of a change in the insureds:

- One single life policy exchanged for second-to-die policy;
- Two single life policies (one each on husband and wife) exchanged by one policyowner for a second-to-die policy on both:
- Two single life policies (one each on husband and wife), owned jointly, exchanged for a jointly owned second-to-die policy on both;
- Trust exchanges single life policy for second-to-die policy;
- Trust exchanges two single life policies (one on each spouse) for a second-to-die policy insuring both.

Survivorship to Single Life: The exchange of a second-to-die contract, however, after the death of the first insured for a single life policy on the survivor qualifies for §1035 non-recognition treatment.[19] In PLR 9330040 the IRS ruled that the exchange of a joint and survivor life policy on insureds A and B after B's death qualified for §1035 treatment. As A was the sole insured on the survivorship policy at the time of the exchange, and was the only insured on the acquired policy, the IRS found that the proposed exchange did not involve a change of insured (and hence was not disqualified from non-recognition treatment).

Survivorship Life to Annuity: The question of whether a survivorship insurance policy may be exchanged for an annuity has not been addressed by the IRS in private or public ruling. Arguably it should be permitted, since the obligees under the annuity could be the same as the owners and insureds under the life policy.

Single Life to Joint & Survivor Annuity: This question has not been addressed directly. Arguably, the owner could accomplish the result by exchanging the life policy for an annuity listing only the insured as the annuitant. At some point later, the owner could change the annuity to a joint and survivor annuity (assuming the contract so allowed).

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[17] Treas. Reg. §1.1035-1(c).

[18] Rev. Rul. 90-109 (1990-2 C.B. 191).

[19] See PLRs 9248013 and 9330040. In these rulings, the IRS stated that it would not rule on whether a survivorship policy exchanged prior to either death for a single life policy would qualify for §1035 treatment.

5. Exchange/Timing

The IRS has determined that the requirements of §1035 prevent non-recognition for exchanges where either (a) the owner has access to cash as part of the transaction or (b) the owner has not made the exchange in a timely manner. As indicated in PLR 9708016 and PLR 9820018, the exchange of one contract for another must be accomplished "simultaneously" in a "single integrated transaction." While there is room for administrative delay beyond the control of the taxpayer, the IRS will likely view with disfavor any combination of transfers occurring over an unreasonably long period. Similarly, the IRS will likely impose a tax where the contract owner receives something other than a new contract.

The safest approach requires the owner to assign the existing policy to the insurer, which surrenders the old policy and issues a new policy.[20] Fortunately for taxpayers, insurers usually will have an internal timetable that will prevent a transaction from lingering beyond the reasonable period allowed by the IRS. In the case of an "inside" exchange – one in which the same insurer issued the surrendered policy and will issue the new policy – the timing of the transaction is more likely to meet the "single transaction" requirement because the disbursement of funds from the old policy may be accomplished without delay caused by another party. In the case of an "outside" exchange involving two or more insurers, the issuer of the new contract generally will limit the amount of time (e.g., 60 days) allowed between the insured's new application and the receipt of the surrender proceeds from the issuer of the old contract.

Timing – Administrative Delay: The surrender and exchange do not have to be simultaneous in a literal sense. For example, the IRS approved a transaction where the owner at different times assigned two insurance policies in exchange for a single annuity, each contract being issued by a different insurer. The ruling includes the following interpretation of the timing requirement:

> *[T]he fact that [insurance] Company A and Company B may process the exchange request at different times should not affect the treatment by Taxpayer of this transaction as a tax-free exchange under section 1035(a). Taxpayer will assign both contracts to Company C at the same time in one integrated transaction and will not at any time in the transaction receive any funds from either Company A or Company B. Administrative delays at any of the participating companies should not cause Taxpayer's otherwise tax-free exchange to become taxable.*[21]

The IRS understands that each insurer's processing speeds may differ, and that there will necessarily need to be some leeway in order to allow the exchange to take place. In each successful exchange ruling, however, the taxpayer has demonstrated that the allowances made were not because of the taxpayer's actions.

Exchange – Cash Made Available to Taxpayer: In order to qualify for non-recognition treatment, the IRS requires that the new contract be issued "in exchange" for an existing contract(s), not in exchange for cash. It follows from this position that a series of transactions in which the taxpayer receives, even temporarily, the cash proceeds from the original contract will not qualify as a §1035 exchange. Revenue Ruling 2007-24 highlights this principle. There a taxpayer attempted to execute a §1035 exchange but the original insurer would only issue a check to the taxpayer (i.e., would not remit the surrender proceeds to the other new insurer). The taxpayer endorsed the check over to the new insurer, which issued a new annuity contract with similar terms. Even though the taxpayer had requested a direct insurer-to-insurer

[20] Rev. Rul. 72-358 (1972-2 C.B. 473).
[21] PLR 9708016

transfer, had not cashed the check, and had accomplished the transactions quickly, nevertheless §1035 was not applicable.[22] The IRS requires a direct assignment of contract values from one company to another.[23]

6. Loans/Boot

An exchange in which the taxpayer receives cash or other property ("boot") in addition to a new insurance or annuity contract may still qualify for non-recognition treatment.[24] However, the non-recognition does not apply to the extent of the value of the cash or other property received in the exchange. Section 1031(b) provides that in such an exchange, the taxpayer will recognize gain, if any, but only to the extent of the boot received.[25] Taxpayers who receive cash, property, a nonqualifying contract, or who are relieved of indebtedness may recognize gain from the exchange of an appreciated life policy or annuity.

The basis of the new contract after the exchange is equal to the original contract's basis, less the cash received, plus the amount of any gain recognized. Where boot consists of property, the basis from the surrendered contract is allocated between the new policy and the property, with the property receiving a portion equal to its fair market value.[26]

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[22] See also PLR 8515063 (January 15, 1985) involving a surrender check made payable to the taxpayer, who endorsed it to the new contract issuer. The IRS ruled §1035 inapplicable since "the elements of an exchange are absent."

[23] The only exception to the "exchange" position taken by the IRS was based on "special facts and circumstances." In PLR 8741052 the IRS allowed a §1035 exchange for annuity holders who would be issued disbursement checks as part of a plan of rehabilitation undertaken by a bankrupt insurer that had settled a number of class action lawsuits. Annuity holders owning nontransferable annuities were permitted to transfer cash distributions received in settlement agreements to a new insurer within thirty (30) days. The IRS conditioned non-recognition treatment, in part, on the execution of a pre-existing binding requirement on the holder to endorse the check to the new annuity issuer. This ruling represents an exception to the IRS general position only insofar as the check was in the taxpayer's possession. This ruling does not violate the general principle (that events have to be beyond the control of the taxpayer) because the taxpayer was legally bound to endorse the check over to the new issuer.
Of further interest is the case of *Greene v. Commissioner*, 85 TC 1024 (1985). The Tax Court ruled against the IRS on the definition of "exchange." In *Greene* the taxpayer surrendered an annuity contract with one insurance company and endorsed the surrender check to a second company for a comparable annuity. The court held that §1035 applied even though the taxpayer was not under a "binding agreement" to hand proceeds over to second insurer. While the IRS acquiesced in the result (see AOD 1986-044 (October 9, 1986), subsequent rulings have illustrated its commitment to requiring a direct assignment of contract values from company to company.

[24] Technically, an exchange of life insurance or annuity contracts involving boot does not fall under §1035, but under §1031(b), which provides for partial non-recognition The Treas. Regulations at §1.1035-1(c) state, in part:
In the case of exchanges which would be governed by §1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see sections 1031(b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035.

[25] §1031(b) states:
If an exchange would be within the provisions of subsection (a) of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

[26] §1031(d).

Gain Greater than Boot: Where the gain in the original contract exceeds the boot received, the entire boot represents gain. For example, an owner exchanges a life insurance policy with $30k cash surrender value ($10k basis) for a new life insurance policy with $20k cash surrender value and $10k cash. The transaction is nontaxable with respect to the new policy value but taxable to the extent of the $10k cash received. The owner's basis in the new policy is $10k [$10k = $10k original basis - $10k cash received + $10k income recognized].

Boot Greater than Gain: Where the gain in the original contract is less than the boot received, the boot represents a distribution of both the contract's gain and a return of basis. For example, an owner exchanges a life insurance policy with $45k cash surrender value ($40k basis) for a new life insurance policy with $35k cash surrender value and $10k cash. The owner recognizes $5k of income (i.e., all of the policy gain). The other $5k cash received is not taxed. The owner's basis in the new policy is $35k [$35k = $40k original basis - $10k boot received + $5k income recognized].

Loss in Original Contract: §1031 also provides that no loss may be recognized on an exchange.[27] For example, an owner exchanges a life insurance contract with a $20k cash surrender value ($50k basis) for a new life insurance policy with a $15k cash surrender value and $5k of cash. The owner recognizes neither gain nor loss. The owner's basis in the new contract is $45k [$45k = $50k original basis – $5k boot received + $0k income recognized.]

Receipt of Nonqualifying Policy: Boot can take the form of cash or other property, even the form of a life insurance contract. Consider an owner of an annuity who exchanges it for an annuity and a life insurance contract. Since an annuity may not be exchanged for a life insurance policy under §1035, the policy represents boot in an annuity for annuity exchange.[28] While partially tax-free, such an exchange would cause the owner to recognize any gain in the original annuity contract up to the value of the policy received. For example, an owner of an annuity with a $100k surrender value ($70k basis) exchanges it for an annuity with an $80k surrender value and a life insurance policy with a $20k fair market value. The life policy represents boot, so the owner will recognize $20k of the $30k gain in the original annuity. The owner's new basis of $90k [$90k = $70k original basis - $0 cash received + $20k income recognized] is divided between the new policy and the acquired annuity, with the policy receiving a portion equal to its $20k fair market value and the acquired annuity receiving the remainder, or $70k.

Policy Loan Extinguished in Exchange: A policy with a loan may be exchanged for another policy or annuity under §1035, but the release of the loan will be treated as if the owner received cash equal to the outstanding loan amount. Treasury Regulation §1.1031(c) provides that the assumption of a liability or a transfer subject to liability is to be treated as "other property or money." Thus, if a policy with a loan is exchanged for a new policy without a loan, the extinguished loan will be considered boot. While this transaction is permissible under the code one should check with their individual carrier to confirm it is permissible with the company and the desired product.

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[27] §1031(c).

[28] See PLR 8905004 (October 7, 1988). The taxpayers withdrew some money from an annuity to buy a life insurance policy, subsequently exchanging the original annuity for a new annuity. The IRS applied the step transaction doctrine, treating the transactions as a §1035 exchange of annuities with the life insurance policy as boot.

For example, an owner has a life policy with $100k cash surrender value ($60k basis) subject to a $20k policy loan. The owner exchanges it in a §1035 transaction for a new policy with $80k cash surrender value and no loan. The loan, because it has not been carried over to the new policy, will be treated as cash boot. As a result, the owner will recognize $20k of gain (i.e., gain up to the value of the boot) as part of the transaction. The owner's basis in the new policy is $60k [$60k = $60k original basis - $20 cash received + $20k income recognized].

Policy Loan Carried Over to New Contract: An exchange of a life insurance policy with a policy loan for a new policy with a loan may qualify for §1035. Although the extinguished loan on the original policy would generally be considered boot, a liability on the acquired policy may defer gain recognition. As provided in the regulations, the liabilities given up and the liabilities assumed should be netted against each other to determine whether the transaction involves boot.[29] As demonstrated in a number of private letter rulings, this means that where the new policy is issued with a loan equal to the loan on the original policy, the owner does not recognize any gain on the transaction.[30] Of course, if the loan on the acquired policy is less than the loan on the original policy, then the difference represents boot that may create gain recognition.[31]

For example, owner executes an exchange of a whole life policy with $100k cash surrender value ($60k basis) and a $20k loan for a variable life policy with a $100k cash surrender value and a $20k loan. The loans offset, leaving a $0 net liability, and therefore no boot. No gain is recognized by the owner, whose basis in the variable policy equals the $60k basis from the whole life policy.[32] Again, while this transaction is permissible under the code one should check with their individual carrier to confirm it is permissible with the company and the desired product.

Exchange following a Partial Surrender of Policy with Loan: A taxpayer may be tempted to avoid extinguished loan gain by first executing a partial surrender of the policy and then effecting an exchange of the now unencumbered policy. Generally, a partial surrender is not a taxable event unless the loan repaid with the surrender proceeds exceeds the contract holder's basis in the contract. The IRS has taken the position, however, that these two transactions equate to an exchange of a contract with an outstanding loan. In PLR 9141025 the IRS invoked the step transaction doctrine to collapse the repayment of the loan and the subsequent §1035 exchange into a single transaction, ruling that the policy owner was taxable on the amount of gain to the extent of the extinguished loan.[33]

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[29] Treas. Reg. §1.1031(b)-1(c) provides that in an exchange under §1031, for purposes of determining boot, "…consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability)."

[30] See e.g., PLRs 8604033, 8806058, and 8816015.

[31] The IRS has not ruled whether the offsetting loan interpretation will apply where the insurance company will not issue the new policy with a loan, as where the taxpayer immediately takes out a loan corresponding to the loan on the original policy. While arguably this transaction might qualify for §1035 treatment because the order of events was required by procedures beyond the control of the taxpayer, such a transaction clearly risks recognition since the original policy loan is not offset by a new loan in the exchange.

[32] See PLR 8806058 for a similar example, in which the IRS writes: "Because the liability encumbering Contract 1 is equal to the liability encumbering Contract 2, for purposes of applying section 1031(b), the liabilities cancel out and no money is deemed to be received by the taxpayer in the exchange of Contract 1 for Contract 2. Therefore, no gain or loss is recognized on such exchange."

[33] PLR 9141025 (July 11, 1991). Under the facts of the ruling, the contract holder intended to effect the exchange immediately following the repayment of the loan. Had the two transactions been separated by a substantial period of time, or had the taxpayer's intention been less obvious, the IRS may not have questioned the exchange.

7. Annuity Issues

Annuity Consolidation: An annuity owner may make a §1035 exchange of two existing annuities for a single annuity. The single annuity may be one of the original contracts, increased in value, or may be a new contract.[34] The new contract's basis is the sum of the original contracts' basis added together.

Annuity Partial Exchange: A partial exchange of an annuity may qualify under §1035. In this kind of one-for-two exchange, the original annuity continues to exist (at a reduced value) after the exchange, along with a new annuity.[35] In other words, the original contract is not fully surrendered as part of the transaction. In the past the IRS had disagreed with the argument that such an exchange qualified for §1035 treatment.[36] However, following a 1998 Tax Court case in which the taxpayer was granted non-recognition, the IRS has acknowledged that in certain circumstances the partial surrender of an annuity (for another annuity) may qualify for §1035 treatment.[37]

Revenue Ruling 2003-76 provides a roadmap for a successful partial exchange.[38] There the taxpayer exchanged sixty percent (60%) of an existing annuity contract for a second annuity issued by a different insurer. The IRS ruled that the partial surrender/exchange qualified under §1035 as a non-recognition transfer, even though the original annuity continued to exist. The taxpayer allocated his basis ratably between the two contracts based on the respective cash values, with sixty-percent (60%) allocated to the new contract and forty-percent (40%) allocated to (i.e. remaining with) the original annuity. The original annuity, reduced in value, was otherwise unaffected by the transaction.[39]

Exchanges must, of course, still meet the requirements of an exchange – the IRS' acquiescence is not a blanket endorsement of all prospective transactions. As stated in AOD 1999-016,

> *"The Service will continue to challenge transactions in cases where taxpayers enter into a series of partial exchanges and annuitizations as part of a design to avoid application of the section 72(q) ten*

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[34] Rev. Rul. 2002-72, 2002-2 CB 812 (November 7, 2002).

[35] For example, Contract A is "exchanged" for a smaller Contract A and Contract B. Conceptually, this should be called a split rather than exchange, but the relevant materials always refer to it as an exchange. This type of transaction differs from the ordinary one-for-two exchange of Contract A for Contracts B and C (see e.g., PLR 9644016 (November 1, 1996)).

[36] See PLR 8741052, in which the IRS disallowed a partial exchange of annuities in circumstances similar to *Conway v. Commissioner* (see note following).

[37] *Conway v. Commissioner,* 111 T.C. 350 (1998), acq. 1999-47 IRB, involved a taxpayer who directed the annuity company to transfer some funds from the annuity directly to a different annuity company, which would issue a new annuity using the (partial) surrender proceeds. In response, the IRS issued AOD 1999-016 (11/22/99), stating that it acquiesced in the 1998 Conway decision in Tax Court. The Conway decision held that a direct transfer of a partial withdrawal from a nonqualified annuity contract qualified as a 1035 exchange. As a result, it may no longer be necessary to surrender a contract to move the money tax free from one carrier to another.
"…as long as all of the funds in the original contract, less any surrender fee, remain invested in annuity contracts after the transaction, and, as long as the proceeds at all times during the transaction remained invested in annuity contracts, the transaction was within the parameters of §1035."

[38] Rev. Rul. 2003-76, 2003-33 IRB 355 (July 9, 2003).

[39] Rev. Rul. 2003-76 holds that the basis must be allocated ratably between the two (or more) contracts.

percent penalty, or any other limitation imposed by section 72. In such cases, the Service will rely upon all available legal remedies to treat the original and new annuity contracts as one contract."

One important fact influencing the fate of a particular transaction is the taxpayer's access (or lack thereof) to the annuity surrender proceeds. In successful exchanges, funds on the original contract went directly from the first insurer to the second. The IRS interprets "access" in a very broad sense when analyzing these transactions. Thus, access refers not only to cash made available to the taxpayer between the partial surrender and the purchase of the new contract, but also to any withdrawal or surrender from either contract for a period of time after the transaction is complete. For example, if a taxpayer partially exchanges annuity A1 for annuity A2 and annuity B, and surrenders annuity B three months later, the IRS will presume that the series of transactions was entered into for tax avoidance purposes. As a result, the transactions will be recast for tax purposes as (1) a taxable surrender of A1, followed by (2) the purchase of annuities A2 and B, and ending with (3) the surrender of annuity B.

Under the most recent guidance applicable to partial exchanges of annuities occurring on or after October 24, 2011, (see Rev. Proc. 2011-38) the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether two annuity contracts are issued by the same company or different companies, will be treated as a Code Sec. 1035 tax-free exchange if no amount, other than an amount received as an annuity for 10 years or more during one or more lives, is received under either the original contract or a new contract during 180 days beginning on the date of transfer. Transfers that do not meet the above conditions will be characterized in a manner consistent with its substance, based on general tax principles and all the facts and circumstances.

Under earlier guidance (see Rev. Proc. 2008-24) effective for partial exchanges that occur before October 24, 2011, a transfer is tax free only if the contract owner does not withdraw any money from, or receive any money in surrender of, either of the contracts involved in the exchange during the twelve-month period beginning with the date of transfer. The rule does not apply to amounts withdrawn from the annuity under the exceptions to the premature distribution rules of Section 72. For example, these are distributions made (1) after the taxpayer turns 59 ½; (2) on or after the taxpayer's death; or (3) as part of a series of substantially equal periodic payments.

Pre-TEFRA Annuity Exchanges: The Tax Equality and Fiscal Responsibility Act of 1982 (TEFRA) altered the taxation of annuities issued after August 13, 1982 by providing that any distribution would be treated first as a distribution of the gain in the contract and second a distribution of basis.[40] Holders of such pre-August 14, 1982 contracts can therefore withdraw their pre-TEFRA basis before having to recognize any gain. Amounts contributed to a grandfathered contract after August 13, 1982, however, will not be grandfathered. The IRS has set forth ordering rules for determining the taxation of amounts withdrawn form contracts with both pre- and post-TEFRA contributions. Amounts withdrawn from such contracts are allocable first to investments prior to August 14, 1982, then to income accumulations with respect to such investments, then to income accumulated with respect to investments after August 13, 1982,

[40] Distributions from annuity contracts, prior to TEFRA, were taxed in the same manner as withdrawals from a life insurance policy are currently; no gain is recognized until the amount withdrawn exceeds the owner's basis. TEFRA also imposed a penalty tax on the taxable portion of any distribution prior to the holder's attainment of age 59½. The original penalty was 5%, but was increased to 10% by the Tax Reform Act of 1986.

and finally to investments after August 13, 1982. The ten percent (10%) penalty tax would only apply to income accumulations attributable to investments after August 13, 1982.

If an annuity contract issued prior to August 14, 1982 is exchanged for a new annuity contract, it will retain its grandfathered status to the extent of contributions made prior to that date and earnings with respect thereto. As a result, holders of pre-TEFRA contracts may want to withdraw their basis in the contracts before requesting a §1035 exchange. Although this transaction would not appear to be taxable, the IRS apparently disagrees. In PLR 8905004 the owner of a pre-TEFRA annuity contract requested a withdrawal of the owner's pre-TEFRA basis in the contract. Simultaneously, the owner requested a §1035 exchange of the remaining value to a new contract with the same insurer. The IRS determined that the taxpayer did not intend to surrender the original contract for cash, but instead intended (in two steps) to exchange the old annuity for a new annuity contract and boot. The IRS ruled, in effect, that the boot rules of §1035 may override the TEFRA income ordering rules when a distribution occurs during a §1035 exchange.

In light of the IRS' strict reading of §1035 in this context, the question arises whether there are any circumstances under which pre-TEFRA basis can be withdrawn from an annuity contract prior to a §1035 exchange without the recognition of gain.[41] The timing of the two transactions would appear to be critical. Even in the absence of an intention at the time of withdrawal to exchange the contract later, an exchange shortly thereafter would likely create a presumption with respect to the contract holder's intention. On the other hand, where the transactions are separated by a significant period of time, any presumed (or actual) intention would be more difficult to establish. Since the IRS is not apt to specify an appropriate waiting period, annuity holders should rely on the advice of counsel when considering such transactions.

Exchange of Annuity Issued Prior to April 23, 1987: The gift of an annuity contract issued after April 22, 1987 will cause the gain in the contract to be taxable to the transferor.[42] In contrast, the gift of a contract issued prior to April 23, 1987 triggers no tax at the time of transfer. Income is only taxed upon the transferee's subsequent withdrawal or surrender of the contract. The IRS has not ruled whether the §1035 exchange of an annuity will preserve this grandfathering, and the legislative history is unclear. However, memoranda have indicated that the IRS will in some cases challenge grandfathering claims made with respect to new annuity contracts received in an exchange, as evidenced by the result in TAM 9346002.

Exchange of an Annuity Owned By a Non-natural Person: Section 72(u) provides that if an annuity contract is owned by a non-natural person, e.g., a corporation, partnership, or trust, the contract will not be treated as an annuity contract for income tax purposes, and the income on the contract will be taxed to the holder each year. This section is applicable to "contributions" to annuity contracts after February 28, 1986. The obvious question is whether a contract will lose its grandfathered status if it is exchanged for a new annuity contract.

Although the law is not clear, an argument can be made in favor of continued grandfather treatment based on the IRS position in Revenue Ruling 85-159, discussed above. That ruling allows the carryover of pre-TEFRA basis in an annuity contract following an exchange. Whether the reasoning also extends to the carryover of grandfathered status in this instance is unclear. Until the IRS issues a pronouncement on the issue, such exchanges will continue to carry risk.

[41] The IRS presumably would apply a similar logic to a case where the exchange shortly precedes the withdrawal.
[42] §72(e)(4)(C)

Post-Death Section 1035 Annuity Exchange: A recent Private Letter Ruling opened up the possibility of 1035 exchanges of nonqualified inherited annuities by a beneficiary. In PLR 201330016, the IRS determined that the beneficiary of an inherited nonqualified annuity became the owner of the contract upon her mother's death, and as the owner was permitted to exchange the original contract for a new contract providing distributions will occur at least as rapidly as they would under the original contract. For example, she could not exchange a contract with only a lump sum payout option for a contract with a life payout option. The ability to facilitate an exchange provides the beneficiary with the option to exchange to a new contract more suitable to their particular needs. One should check with their insurance carrier to determine whether this 1035 option is available to them as beneficiary of an inherited nonqualified annuity.

8. Miscellaneous Issues

MEC – Material Change: Whether a new policy issued in a §1035 exchange will be a modified endowment contract ("MEC") depends on the status of the original policy given up in the exchange.[43] If the original policy was a MEC, the new policy received also will be a MEC.[44] If the original policy was not a MEC, the new policy will not be a MEC solely because of the exchange of cash values. Stated another way, unless the owner contributes cash (i.e., in addition to the original contract's surrender values) as part of the transaction, an insurance policy received in exchange for a non-MEC policy will not become a MEC.

However, for purposes of MEC testing, the §1035 exchange is a material change requiring a new seven-pay test on the new policy.[45] As a result of the use of the original contract's values, an exchange may significantly reduce the future premiums that may be paid without violating the new policy's MEC limits.[46] This will be of particular concern for policy owners who wish to contribute cash as part of the exchange into the new policy. Cash contributions, whether made as part of the exchange or in the form of future premiums, will count toward the MEC limits.[47]

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[43] A MEC is any contract meeting the requirements of §7702 (defining life insurance) entered into after June 20, 1988 but which fails to meet the seven-pay test of §7702A(a)(1). The death benefits of MECs are received, as are other life insurance contracts – generally income tax free. However, the income tax rules applied to lifetime distributions from a MEC resemble those for annuities; distributions (including loans) will be deemed to be taxable to the extent of any gain in the contract. Premature MEC distributions are subject to an additional 10% penalty tax. See §72(v)(1).

[44] §7702A(a)(2).

[45] See PLR 9044022.

[46] In applying the seven-pay test to premiums paid under the new contract, the seven-pay premium for each of the first seven contract years after the exchange is to be reduced by a formula that depends on the cash values from the original contract: (a) the cash surrender value of the new contract, multiplied by a fraction, the numerator of which is (b) the seven-pay premium for the new contract and the denominator of which is (c) the net single premium for the same new contract. See the Conference Report to accompany H.R. 4333, the "Technical and Miscellaneous
Revenue Act of 1988" (H. Rep. No. 100-1104), Oct. 21, 1988, vol. II, p. 105.

[47] Other premium limits are, of course, still applicable and may independently reduce the amount of additional cash that may be added as part of the transaction. For example, to qualify as life insurance, a policy still has to meet the TEFRA limits (e.g., the guideline premium test or the cash value accumulation test) as part of the exchange. See §7702(b)(1) and (c)(1).

Contracts grandfathered from MEC testing (i.e., policies issued prior to June 21, 1988) will lose their grandfathered status as a result of the exchange.[48] Consequently, in an exchange of a grandfathered policy, the newly issued policy must not violate the seven-pay test to avoid future MEC status.

MEC – Aggregation for §72 Distribution: Distributions "not received as an annuity" from a MEC are included in income to the extent of gain in the contract.[49] Only after the gain has been depleted does the owner receive nontaxable distributions of basis. Importantly, for these purposes, all MECs issued by the same company in the same calendar year to the same policyholder will be treated as a single MEC.[50] This aggregation rule was enacted to prevent taxpayers from avoiding the gain-first problem through the purchase of several smaller MEC policies instead of a single larger MEC. The IRS has ruled that where a taxpayer who owns several MECs issued by one insurance company exchanges some of them for MECs issued by a second company, the new contracts are not aggregated with the old contracts for §72(e) purposes. [51]

For example, Owner has four MEC policies (A,B,C,D) issued by Old Insurance Company in 2004. In 2007 Owner executes a §1035 exchange of policies C and D, receiving new policies Y and Z from New Insurance Company. In 2008 Owner takes a distribution from policy A. For purposes of determining the portion of the distribution that is taxable, Owner must aggregate policies A and B, but may exclude policies Y and Z.

Split-Dollar and Exchanges: There are no rulings specifically addressing whether a policy subject to a split-dollar agreement may be exchanged under §1035. However, it stands to reason that since a split-dollar agreement is a third-party contract affecting ownership (and not the policy itself), as long as the other elements necessary for a proper exchange are present (e.g., same owner, same insured) then a split-dollared policy may be exchanged for another. Of course, the split-dollar agreement itself may contractually preclude an exchange. In addition, a §1035 exchange will likely be considered a material change for split-dollar purposes. An exchange, therefore, may result in the loss of grandfathered tax treatment. Generally, this will be of concern for owners of policies issued prior to September 18, 2003, or January 28, 2002, if the insurer's alternative term rates are used to value the life insurance protection.

Exchanges Involving Foreign Contracts: An exchange involving a contract issued by a foreign insurance company can still qualify for non-recognition treatment under §1035 as long as the contract meets the definition of life insurance or an annuity under U.S. law. In PLR 9319024, the taxpayer owned a deferred annuity contract issued by a domestic company.[52] The taxpayer proposed to exchange the annuity via a direct assignment for an annuity issued by foreign insurance company. Citing the legislative history of §1035(a) the IRS said that "the focus of the exchange rule should be on the character and benefits of the contract rather than on the particular tax status of the company issuing the contract." The fact that the issuer of one

[48] The General Explanation of the Deficit Reduction Act of 1984 (DEFRA) indicates that policy exchanges that result in a "change of terms" will eliminate grandfathering. In practice, most exchanges will so lose grandfathered status, as a change of terms includes changes to: the amount of death benefit; the payout pattern of the death benefit; the premium pattern; the accumulation rate guaranteed; the mortality or expense charges.
[49] §72(e)(1).
[50] §72(e)(12)(A)
[51] Rev. Rul. 2007-38 , 2007 IRB 1420 (May 30, 2007)
[52] PLR 9319024 (February 10, 1993).

contract was domestic and the other foreign was deemed "irrelevant." [53] As indicated in the paragraph following, some commentators believe this treatment will change when (or if) the IRS issues new §1035 regulations.

Exchanges Involving Foreign Persons: There is some uncertainty related to exchanges made by foreign persons (individuals or entities). This stems from §1035(c), which reads:

> *EXCHANGES INVOLVING FOREIGN PERSONS: To the extent provided in regulations, subsection (a) shall not apply to any exchange having the effect of transferring property to any person other than a United States person.*[54]

As of this writing, the IRS has not yet issued regulations interpreting this provision, so exchanges involving foreign owners may still qualify for non-recognition. However, under this provision the IRS has regulatory authority to deny §1035 non-recognition treatment in future transactions involving foreign persons even where the policy is issued by a U.S. insurance company. Theoretically, such regulations might capture not only transfers in whom the policy owner or annuity obligee is a noncitizen, but also transfers involving foreign insurers.

"1035 Into A Trust": This phrase describes situations where the taxpayer would like to accomplish two objectives in a single transfer: (1) execute a §1035 exchange of a life insurance policy; and (2) transfer the policy to an irrevocable trust (ILIT). That is, the taxpayer applies for a §1035 exchange, but names ILIT as owner of the new policy. In most cases, the desire to transfer the policy stems from an estate planning concern. The insured hopes to avoid having the policy death benefit included in the estate by reason of owning the policy at death or by reason of making a gift within three years of death.[55] In general, a "1035 into a trust" should be viewed as two distinct transactions, namely a section 1035 exchange by the owner of the old contract followed by a transfer to the trust by such owner. In the case of a gift transfer, this would be treated as a gift to the trust and will generally result in the acquired policy being included in the estate under the three-year rule, though the IRS has not specifically addressed this fact pattern.

Premium Taxes, External Exchange: The §1035 rules only provide for non-recognition of any gain inside an exchanged policy. State and federal insurance tax laws will still apply to external money used for the acquired (new) policy. Consequently, if premium values come from an exchange assignment from another insurer, the new policy will have full premium loads and federal and state (if applicable) taxes deducted from the policy. Only internal exchanges (i.e., where the same insurance company issued the original contract and the new contract) will escape premium charges.

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[53] §1035(b) was amended by both the Deficit Reduction Act of 1984 (Pub.L. 98-369, 98 Stat.776) and the Tax Reform Act of 1986 (Pub.L. 99-514, 100 Stat. 2851). It changed from requiring the policy to have been issued by a life insurance company as defined in §801 to requiring merely that the policy have been issued by "an insurance company." The legislative history of the latter Act indicates the following explanation: "The [TRA '96] bill amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code."

[54] §1035(c), added by the Taxpayer Relief Act (TRA) §1131(b)(1), PL 105-34 (August 8, 1997) in an effort to curb abuse related to offshore property transfers.

[55] See §2042 and §2025.

9. Conclusion

The ability to defer gain in a life insurance, annuity, or endowment contract through a §1035 exchange can be of significant benefit to a policyholder. As the discussion above indicates, however, it is important that the exchange be effected correctly, and that the owner consider all potential tax implications. Failure to do so may not only result in the loss of deferral, but the loss of a client as well.

Legal & Tax Trends is provided to you by a coordinated effort among the Advanced Markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele B. Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, and Barry Rabinovich. All comments or suggestions should be directed to Tom Barrett, tbarrett@metlife.com or John Donlon, jdonlon@metlife.com.

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Metropolitan Life Insurance Company
200 Park Avenue
New York, NY 10166

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