Internal Revenue Service

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Department of the Treasury

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Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

GC:DOM:FI&P:4-PLR-100145-98

Date:

SEP 30 1998

Taxpayer A =

Taxpayer B =

Program =

Entity A =

Contract A =

Agreement =

State B =

Date C =

Date D =

Date E =

Dear

This letter responds to your request dated Date D and the request of Taxpayer A on Date C, for several rulings regarding the treatment of a proposed exchange of one annuity contract for one or two annuity contracts under section 1035 of the Internal Revenue Code (the "Code") and the application of section 72(q)(1) to the exchange of an annuity contract. Additional information was submitted on Date E. By letter dated September 30, 1998, Taxpayer A and Taxpayer B have withdrawn the issues relating to section 72(e)(4) relating to the pledging of an annuity.

213

Facts

Taxpayer B is a resident of State B and has agreed to participate in Program developed by Taxpayer A. Taxpayer A is a licensed insurance general agent providing insurance related services to lending institutions. Taxpayer A developed Program to be offered to individuals, like Taxpayer B, through Entity A. Program combines a mortgage loan with an annuity contract to enable an individual to purchase a residence and simultaneously invest what would generally constitute a cash down payment as a single payment tax-deferred annuity contract issued by an insurance company. Program is intended to graft an investment component on the traditional "cash" down payment requirement of a residential purchase transaction through the use of an annuity contract as consideration to make the down payment.

At the time Taxpayer B enters into Agreement, the cash value of the annuity contract does not exceed Taxpayer B's investment in Contract A. The investment component of Contract A is pledged at the time Taxpayer B borrows funds from Entity A to acquire residence. Once the investment component of Contract A is assigned by Taxpayer B, subsequent assignments of the investment component of Contract A by Taxpayer B are prohibited. Thus, the amount pledged to Entity A as collateral remains limited to the amount of Taxpayer B's initial investment in Contract A at the time that Contract A was acquired from the issuing insurance company.

As part of Program, Taxpayer B is entitled to exchange Contract A for one or two annuity contracts issued by the same or another insurance company and the investment component of the original Contract A continues to be subject to Agreement, serving as security for the mortgage loan on the new residence. Upon expiration of the term of the mortgage or the complete satisfaction of the sums due thereunder, Taxpayer B is entitled to (a) retain Contract A in full force and effect, or (b) take a lump sum distribution from Contract A. If Taxpayer B discontinues participating in Program, Agreement is terminated and the Entity A releases the investment component as its collateral. If Taxpayer B defaults under the terms of the mortgage loan agreement with Entity A, Entity A under Agreement could request that the issuer of Contract A turn over to it an amount equal to the lesser of the outstanding balance of the mortgage loan or the investment component of Contract A, which is the amount pledged by Taxpayer B. The income component of Contract A, representing the interest earned and the accrued after the end of the third year of Contract A's effective date, is then paid to Taxpayer A.

Law and Analysis

Section 72(e) of the Code provides guidance for the tax consequences of amounts not received as annuities received by a taxpayer. Section 72(e)(2) provides that generally, if such amount is received on or after the annuity starting date, it is included in gross income and if such amount is received before the annuity starting date, then such amount is included in gross income to the extent allocable to income on the contract. Section 72(e)(4)(ii) provides that if, during any taxable year, an individual assigns or pledges (or agrees to assign or pledge) any portion of the

value of any such contract, then such amount is treated as received under the contact as an amount not received as an annuity.

Section 1035(a)(3) of the Code provides that no gain or loss shall be recognized on the exchange of an annuity contract for an annuity contract. For this purpose, section 1035(b)(2) defines the term "annuity contract" as a contract with an insurance company and which depends, in part, on the life expectancy of the insured-annuitant but which may be payable during the life of the annuity only in installments.

Section 1.1035-1 of the Income Tax Regulations provides that "[t]he 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 the exchange as under the original contract."

The House Committee Report to the Internal Revenue Code of 1954 indicates that section 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." H. R. Rep. No. 1337, 83 Cong., 2d Sess. 81 (1954). Accordingly, section 1035 operates as the insurance analogue to section 1031, which relates to like-kind exchanges of certain types of property held for productive use in a trade or business or for investment. The similarity of section 1031 and section 1035 is evidenced in section 1035(c)(1), which provides that the recognition of gain or loss on an exchange that is not solely like-kind will be made under the terms of section 1031(b) and (c). In addition, section 1035(c)(2) states that section 1031(d) provides rules relating to the basis of property acquired in an exchange described in section 1035(a). Section 1031(b), (c), and (d) similarly cross-reference section 1035(a).

Section 1031 of the Code permits exchanges of more than one property for one property. See section 1.1031(j)-1 (relating to exchanges of multiple properties). See also Rev. Rul.. 85-135, 1985-2 C.B. 181 (exchange of assets of two television stations for the assets of another television station permitted) supplemented by Rev. Rul. 89-121, 1989-2 C.B. 203.

Because section 1035(a)(1) is written in the singular, one might argue that it does not apply to the exchange of one annuity contract for two annuity contracts. However, section 7701(m)(1) cross-references Title A, section 1 of the United States Code, which provides that "[i]n determining the meaning of any Act of Congress, unless the contact indicates otherwise, words importing the singular include and apply to several person, parties, and things." Thus, just as section 1031 applies to exchanges of multiple properties, section 1035(a)(1) apples to exchanges of annuity contracts.

Section 72(q) of the Code imposes a penalty on premature distributions form annuity contracts. The penalty is equal to 10 percent of the portion of the distribution that is includible in gross income.

There are certain exceptions and limitations to section 72(q) of the Code. The penalty does not apply to a distribution that is allocable to an investment in the contract made before August 14, 1982. H.R. Rep. No. 97-760, 97th Cong., 2d. Sess 647 (1982), 1982-2 C.B. 600, 686 states, referring to the preceding sections: "[A] replacement contract obtained in a tax-free exchange of contracts succeeds to the status of the surrendered contract for purposes of the new provisions." See Rev. Rul. 85-159, 1985-2 C.B. 29 and Rev. Rul. 92-95, 1992-1 C.B. 43. Thus, the new annuity contract(s) received in the tax-fee exchange are not considered new contracts for purposes of section 72(q).

Conclusion

1) The exchange of Contract A issued by Entity A for one annuity contract issued by the same or another insurance company qualifies as a tax-free exchange under section 1035(a)(3) if : (a) the investment component of the exchanged Contract A is assigned, pursuant to Agreement, as collateral for a mortgage loan issued by a lender to Taxpayer B for the purchase of a residence; (b) the annuity exchange transaction does not take place in connection with Taxpayer B's refinancing, sale, exchange, or other disposition of the residence acquired by Taxpayer B with the mortgage loan; (c) the investment component of the exchanged Contract A (i) is invested in a second annuity contract and (ii) also serves as security for the same subject mortgage loan on the same residence; (d) the income component of the exchanged Contract A also is invested in the same annuity contract; and (e) the investment component remaining subject to Agreement through the course of the exchange transaction.

2) The exchange of Contract A issued by Entity A for another annuity contract issued by the same or another insurance company qualifies as a tax-free transaction under section 1035(a)(3) if: (a) the investment component of the exchanged Contract A is assigned, pursuant to Agreement, as collateral for a mortgage loan issued by a lender to Taxpayer B for the purchase of a residence; (b) the annuity exchange transaction takes place in connection with Taxpayer B's refinancing of the residence acquired by Taxpayer B with the mortgage loan or Taxpayer B's sale, exchange, or other disposition of the initial residence acquired by Taxpayer B with the mortgage loan; (c) the investment component of the original Contract A (i) is invested in a second annuity contract and (ii) also serves as collateral, pursuant to the Agreement, for a new mortgage loan that is (A) provided by the same of different mortgage lender, and (B) also serves as security for the subject mortgage loan on the initial or another residence acquired by Taxpayer B; (d) the income component of the exchanged Contract A also is invested in the same annuity contract; and (e) throughout the course of the exchange transaction of the investment component remains subject to Agreement.

3) The exchange of Contract A issued by Entity A for up to two other annuity contracts issued by the same or another insurance company qualifies as a tax-fee transaction under section 1035(a)(3) if: (a) the investment component of the exchanged Contract A is assigned, pursuant to an Agreement, as collateral for a mortgage loan issued by a lender to Taxpayer B for the purchase of a residence; (b) the annuity exchange transaction does not arise from Taxpayer B's refinancing, sale exchange, or other disposition of the residence acquired by Taxpayer B with the mortgage loan; (c) the investment component of the original Contract A (i) is invested in the other annuity contracts and (ii) also serves as collateral for the initial mortgage loan that is secured by the residence acquired by Taxpayer B; (d) the income component of the exchanged Contract A also is invested in the same annuity contacts; and (e) the investment component remains subject to Agreement through the course of the exchange transaction.

4) The exchange of Contract A issued by Entity A for up to two other annuity contacts issued by the same or another insurance company qualifies as a tax-free transaction under section 1035(a)(3) if: (a) the investment component of the exchanged Contract A is assigned, pursuant to Agreement, as collateral for a mortgage loan issued by a lender to Taxpayer B for the purchase of a residence; (b) the annuity exchange transaction arises from Taxpayer B's refinancing of the mortgage loan or the Taxpayer B's sale, exchange, or other disposition of the residence acquired by Taxpayer B with the mortgage loan; (c) the investment component of the original Contract A (i) is invested in up to two other annuity contacts and (ii) also serves as collateral, pursuant to Agreement, for a new mortgage loan that is (A) provided by the same or different mortgage lender, and also (B) serves as security for the same subject mortgage loan on the residence acquired by Taxpayer B; (d) the income component of the exchanged Contract A also is invested in the other annuity contacts; and (e) the investment component remains subject to Agreement throughout the course of the exchange transaction.

5) The exchange of Contract A issued by Entity A for one or two other annuity contracts issued by the same or other insurance company under the situations described above is not treated as a new contract for purposes of section 72(q)(1) and each replacement annuity contract retains the attributes of the exchanged Contract A for purposes of determining when amounts are considered to have been invested in each replacement annuity contract.

Except as specifically set forth above, no opinion is expressed as to the tax treatment of Contract A or any other contract under the provisions of any other section of the Code or the regulations. Specifically, no opinion is expressed as to the application of section 72(e)(4) of the Code to any contracts involved in Program.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the next federal income tax return to be filed by Taxpayer A and Taxpayer B.

A copy of this letter will be sent under separate cover to Taxpayer A.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: Donald J. Drees Jr.
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Branch 4