

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4-PLR-142960-02
Date:

February 20, 2003

Legend

Taxpayer A =

Taxpayer B =

Trust C =

Subtrust D =

Subtrust E =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Contract A =

Contract B =

Contract C =

Dear :

This is in response to a ruling request dated Date 1, as supplemented by correspondence dated Date 2 and Date 3, in which you request rulings under sections 72 and 408(d) of the Internal Revenue Code (the "Code"). By virtue of the correspondence dated Date 2, our office is not considering the first and second ruling

requests contained in your original submission related to section 408(d) of the Code. Those requests were handled separately by letter dated October 29, 2002 (PLR 200304037).

The following facts and representations have been submitted in support of the rulings requested:

Taxpayers A and B were married. On Date 4, Taxpayers A and B created Trust C, a revocable, inter vivos trust. Taxpayers A and B were the grantors, co-trustees, and beneficiaries of Trust C. The trust agreement provided that the survivor of Taxpayer A and Taxpayer B would be the surviving grantor/trustee and sole beneficiary of Trust C. Subsequently, Taxpayer A transferred ownership of two deferred variable Annuities (Contracts A and B) to Trust C and named Trust C the beneficiary of Contracts A and B. Taxpayer A died on Date 5 before the starting date of the Annuities.

Trust C is an A/B type trust which, upon the first death of a grantor is to be divided into two subtrusts, "Subtrust D", a survivor's trust, and "Subtrust E", a credit shelter trust. Taxpayer B, as surviving grantor/trustee, has the power of allocation between the subtrusts of Trust C and is the trustee and beneficiary of both subtrusts. With respect to Subtrust E, Taxpayer B is entitled to all net income to that trust and can invade the principal on an unascertainable standard. Further, Taxpayer B has the right to withdraw the entire or any amount of income and/or principal from Subtrust D, and this right cannot be limited by trustee discretion.

Taxpayer B, as surviving spouse, proposes to transfer Contracts A and B from Trust C to Subtrust D and exchange Contracts A and B for a new deferred variable annuity contract (Contract C). Contract C will be issued in favor of Taxpayer B. (Taxpayer B will be both owner and beneficiary.) At no point in the exchange will Subtrust D or Taxpayer B receive any money or property other than Contract C.

Based upon the foregoing, you have requested rulings that:

1. Taxpayer B will be considered the "designated beneficiary" of the Annuities (Contracts A and B) within the meaning of section 72(s)(4) of the Internal Revenue Code; and
2. The proposed exchange of Contracts A and B for Contract C will qualify for nonrecognition treatment under section 1035.

ISSUE 1:

Section 72 provides a comprehensive scheme for the taxation of life insurance, endowment, and annuity contracts. Section 72(a) and (b) provide, in general, for the taxation of "amounts received as an annuity." Section 72(e), in general, taxes amounts received under life, endowment, and annuity contracts that are "not received as

annuities."

Section 72(s) in general provides that a contract will not be treated as an annuity contract for federal income tax purposes unless, with certain exceptions, it provides for certain distributions in the event that the holder of the contract dies.

Under section 72(s)(1)(A), the contract must provide that if any holder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distribution being used as of the date of death.

Under section 72(s)(1)(B), the contract must also provide that if any holder dies before the annuity starting date, the entire interest in the contract will be distributed within five years after the holder's death.

Section 72(s)(2) provides an exception for certain amounts payable over the life of a designated beneficiary. Specifically, 72(s)(2) provides that if:

(A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary (defined in section 72(s)(4) of the code as any individual designated a beneficiary by the holder of such contract),

(B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe, then for purposes of section 72(s)(1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which the distributions begin.

Section 72(s)(4) defines "designated beneficiary" as "any individual designated a beneficiary by the holder of the contract."

Section 72(s)(3) provides that if the designated beneficiary referred to in section 72(s)(2)(A) is the surviving spouse of the holder of the contract, sections 72(s)(1) and (2) shall be applied by treating such spouse as the holder of such contract.

In this instance, although Trust C is the named holder and beneficiary of Taxpayer A's Annuities, Taxpayer B has the right to allocate funds between Subtrust D and Subtrust E upon the division of Trust C at Taxpayer A's death, and to withdraw all of the principal of Trust C from Subtrust D. Taxpayer B thus has complete control and dominion over Trust C and Subtrusts D and E, and over the disposition of the assets of Trust C and Subtrusts D and E. Taxpayer has represented that Trust C, Subtrust D and Subtrust E are grantor trusts for purposes of the Code and Income Tax

Regulations. As a result, Taxpayer B is treated as the owner of the assets of Trust C, Subtrust D, and Subtrust E (including Contracts A and B). Under section 671, Taxpayer B must take into account items of income deductions and credits attributable to the assets of the trusts (including Contracts A and B).

Based upon the facts and representations set forth above, we conclude that Taxpayer B is the designated beneficiary of Contracts A and B within the meaning of section 72(s)(4).

ISSUE 2:

Section 1035(a) of the Code provides that no gain or loss shall be recognized on the exchange of an annuity for another annuity contract. For this purpose, section 1035(b) 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 annuitant only in installments. See sections 72(s) and (u), setting forth certain situations in which a contract is not treated as an annuity contract for purposes of various tax provisions, including section 1035.

Section 1.1035-1(c) of the Income Tax Regulations provides 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 obligees under the contract received in the exchange as under the original contract."

In this instance, although Trust C is nominally the obligee under Contracts A and B, as explained above, Taxpayer B is the owner of Contracts A and B for tax purposes and the designated beneficiary under section 72(s)(4). Taxpayer accordingly is the obligee of Contracts A and B within the meaning of section 1.1035-1(c) of the regulations. Because Taxpayer B will also be the obligee under Contract C, the same obligee requirement of section 1.1035-1(c) will be satisfied.

The legislative history 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, 83rd Cong., 2d Sess. 81 (1954). Thus, 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 permits exchanges of one property for more than one property. See 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); Rev. Rul. 73-476 1973-2 C.B. 300 (exchange of three undivided interests in three parcels of land for 100 percent ownership in one parcel).

Because section 1035(a)(3) is written in the singular, one might argue that it does not apply to exchanges of one annuity for two annuities or exchanges of two annuities for one annuity contract. However, section 7701(m)(1) cross-references Title I, section 1 of the United States Code, which provides that "in 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." Thus, just as section 1031 applies to exchanges of multiple properties, section 1035(a)(3) applies to exchanges of multiple annuities.

Accordingly, based solely on the information submitted and the representations made, we conclude with respect to your ruling request, as follows:

1. That Taxpayer B will be considered the "designated beneficiary" of Contracts A and B within the meaning of section 72(s)(4); and
2. That the proposed exchange of Contracts A and B for Contract C will qualify for nonrecognition treatment under section 1035.

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or references in this letter under the provisions of any other section of the Code or the Income Tax Regulations. Specifically, no opinion is expressed as to whether or not the annuities are in fact annuity contracts under section 72 of the Code or as to whether they meet the requirements of section 72(s) .

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Mark Smith
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)