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Revenue Procedure 2008-24 and Partial Annuity Exchanges: Where Are We?

by Kirk Van Brunt

The Internal Revenue Service (IRS) issued Rev. Proc. 2008-24 in March of this year, addressing the income tax treatment of so-called "partial annuity exchanges" ("partial exchanges"). Rev. Proc. 2008-24 answers some important questions, but it leaves other questions unanswered, particularly with respect to so-called "partial annuitizations." On balance, in Rev. Proc. 2008-24 the IRS has attempted to provide a fair solution to the partial exchange problem, but some of the terms of Rev. Proc. 2008-24 are open to interpretational debate and the ultimate utility of Rev. Proc. 2008-24 depends on how these interpretational issues are resolved.

This article begins with an overview of partial exchanges and the basic tax rules that they implicate. The article then reviews some of the history in this area leading up to Rev. Proc. 2008-24 and after that provides a detailed discussion of Rev. Proc. 2008-24. The article finishes with a discussion of partial annuitizations and "modified endowment contracts."

Overview

A holder of a "nonqualified" deferred annuity contract may wish to withdraw part of the account value of the contract and use the funds elsewhere.[1] Perhaps the easiest way to do this is to request the issuing insurance company to take the desired amount out of the account value and send the contract holder a check. This is referred to as a "partial withdrawal."

> *Example (1)*—John, age 54, purchased a deferred annuity contract in 2000 for $60,000, and now the account value has grown to $100,000. The contract was issued by XYZ Life Insurance Company. John wishes to withdraw the $40,000 of account value growth. XYZ sends him a check for this amount.

Partial withdrawals, however, can trigger adverse tax consequences. First, the partial withdrawal is treated as a distribution of taxable ordinary income to the extent of the "income on the contract."[2] In John's case, that means the entire $40,000 amount is taxable. Second, since John is under age 59½, a 10 percent premature withdrawal penalty applies (assuming no penalty exceptions apply).[3] In this case, this means that the income tax otherwise due on the $40,000 amount is increased by $4,000.

The partial exchange is an alternative to a partial withdrawal that may not have the same adverse tax consequences. What is a partial exchange? A partial exchange is a transaction in which the holder transfers a portion of the account value of an existing deferred annuity contract to the same or a new life insurance company in exchange for a new annuity contract. This may be done, for example, by assigning a portion of the contract's account value. The remaining portion of the account value of the original deferred annuity contract is then retained in the "old" contract.

> *Example (2)*—Instead of a partial withdrawal, on July 1, 2008, John assigns $40,000 of his contract's value to ABC life insurance company

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in exchange for ABC issuing to him a new deferred annuity contract. John now owns two annuities: the old XYZ annuity, now with an account value of $60,000, and the new ABC annuity, with an account value of $40,000.

What is the tax treatment of a partial exchange? John would like to take the position that this is an exchange of annuity contracts that is tax-free under section 1035. Under this view, John does not pay tax on the $40,000 amount and there is no $4,000 penalty tax either. Later, John may surrender or take withdrawals from either the new annuity or the old annuity and pay tax only by reference to the gain inside the particular contract involved. A premature withdrawal penalty may still apply, but since the taxable gain is less, the penalty will be less. If this treatment is correct, then a partial exchange is a more favorable tax strategy than a straight partial withdrawal.

There are, however, alternative ways to view a partial exchange. One way in particular, for example, would be to view a partial exchange as simply a withdrawal of money from the deferred annuity contract, which is then used to purchase a new annuity contract and which should be treated in the same manner as a straightforward partial withdrawal. Section 1035, one might argue, was not meant to be a tool for doing an end run around the rules applicable to partial withdrawals. Under this view, the fact that the money being withdrawn happens to be applied in a specific manner—*viz.*, to purchase another deferred annuity contract—should not matter; John should be taxed in the same manner as he would if he simply withdrew the $40,000 and spent it all on a new home theater system.

There is one final twist to consider. Back in 2000, let us assume that John wants to purchase the deferred annuity contract in question, but he is concerned about the adverse treatment of partial withdrawals. After some thought, John decides that he will ameliorate the adverse tax consequences by buying five separate deferred annuity contracts from XYZ for $12,000 each (for a total cost of $60,000). Each contract now has a value of $20,000 (for a total value of $100,000). Later, John decides to effect a withdrawal of $40,000 from the five contracts by completely surrendering two of them. Upon a complete surrender, the holder is taxable only on the amount received in excess of his investment in the contract. In this case, John has an $8,000 gain on each contract and thus pays tax on a total of $16,000 (as opposed to $40,000). While John still must pay a premature withdrawal penalty, the penalty in this case is $1,600, not $4,000. In this manner, John has cleverly lessened the adverse tax consequences that would have otherwise applied if John had just bought a single deferred annuity contract. Or has he? The answer is John's plan does not work. Congress anticipated this technique back in 1988 and enacted a special aggregation rule under which all annuity contracts issued by the same company to the same policyholder during any calendar year are treated as a single contract.[4] In addition, Congress gave the IRS broad regulatory authority to prescribe regulations to prevent avoidance of section 72(e).[5]

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Some History

The appropriate tax treatment of a partial exchange has long been the subject of disagreement and debate. An appropriate starting point in reviewing the history of the issue is *Conway v. Commissioner*.[6] The facts of *Conway* are simple. Dona Conway bought a deferred annuity contract from Fortis Benefits Insurance Company in 1992 for $195,643. In 1994, she instructed Fortis to withdraw $119,000 from the contract and to make the check out to Equitable Life Insurance Company of Iowa. A check was issued by Fortis directly to Equitable for $109,000 ($119,000 minus a $10,000 surrender charge) and Equitable issued a new deferred annuity contract to Ms. Conway. On her tax return, Ms. Conway treated the transaction as a tax-free exchange under section 1035. On audit, the IRS treated the transaction, not as a section 1035 exchange, but as a simple partial withdrawal. The Tax Court sided with Ms. Conway, and rejected the IRS's argument that in order to qualify under section 1035, Ms. Conway would have needed to exchange the entire Fortis contract.

The IRS decided to acquiesce in the *Conway* decision, but with an important caveat. The taxpayer could not be guilty of using the partial exchange transaction purely as a device to avoid the adverse tax consequences of a partial withdrawal.[7] Thus, the IRS concluded, the taxpayer must leave the funds inside both the "old" contract and

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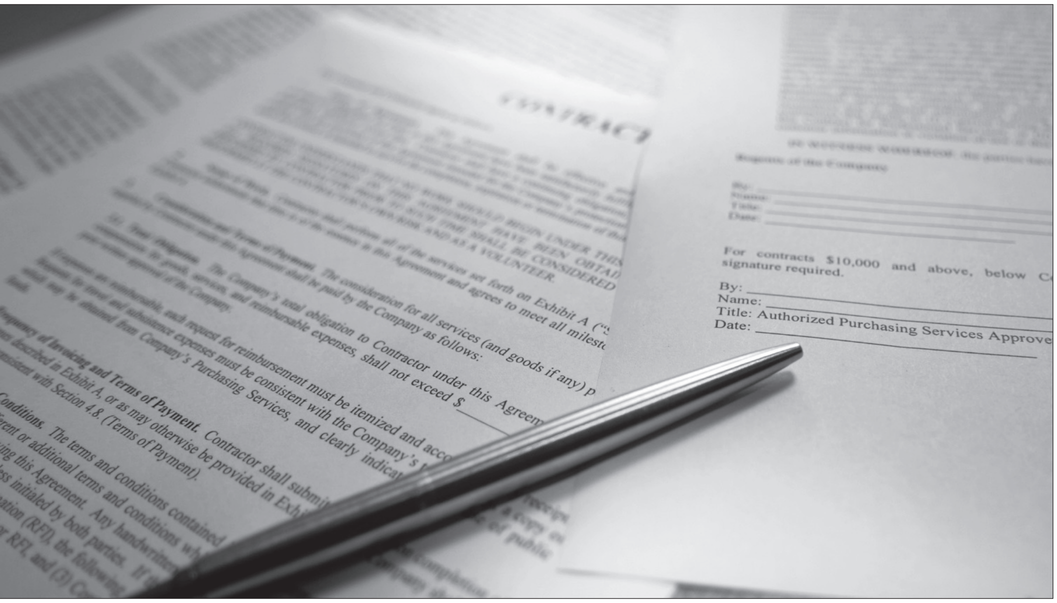

the "new" contract received in the exchange; the taxpayer cannot try to pull money out of either contract. An example of the type of transaction that concerned the IRS would be where, to refer to the partial exchange example (2) on page 1, John receives a new deferred annuity contract on July 2, 2008, and on July 3, John surrenders the new contract for $40,000. Obviously, John is in the same position he would have been in had he simply undertaken a partial withdrawal, and the IRS vowed to fight transactions of this ilk.

However, as long as the contract holder was willing to leave the money in the two contracts for some undefined period of time, the IRS agreed with the *Conway* case that a partial exchange would be treated as a tax-free exchange under section 1035. The obvious question that arose after the IRS's acquiescence was how long does the money have to remain in the contracts? When does the partial exchange transaction become "old and cold" relative to a later surrender of, or withdrawal from, one of the contracts? There was no clear answer to that question.

The upshot of the *Conway* case was that John could engage in the partial exchange transaction described in example (2) on page 1 and achieve the desired section 1035 treatment, provided John did not attempt to take any money out of either contract for some undefined period of time. However, if John did attempt to take money out of either contract too soon, the IRS reserved the right to challenge such transactions, the *Conway* decision notwithstanding.

In the aftermath of the *Conway* decision and the IRS's acquiescence therein, the industry pressed the IRS for further guidance on partial exchanges. In addition to the question of when the partial exchange transaction became "old and cold," various technical questions were raised, perhaps the most prominent being how the contract holder's original investment in the contract should be allocated between the old and new contracts. The IRS's response to these questions came in the summer of 2003 with the issuance of Rev. Rul. 2003-76[8] and Notice 2003-51.[9]

Rev. Rul. 2003-76 formally confirmed that a partial exchange involving facts similar to those in *Conway* would be treated as a valid section 1035 exchange, and it answered the question of how to allocate the investment in the contract. The allocation is done on the basis of the percentage of the cash value retained in the original contract and the percentage transferred to the new contract. Surrender charges are ignored.[10]

The other piece of guidance, Notice 2003-51, was more intriguing. It provided interim guidance, pending future regulations, on when a partial exchange would be respected as a tax-free section 1035 exchange and when it would be subject to attack as a tax avoidance device for dodging the adverse tax consequences that apply to partial withdrawals. Notice 2003-51 created a safe harbor. If the holder undertakes a partial exchange and does not surrender, or take a withdrawal from, either contract within 24 months of the date when the partial exchange was completed, the partial exchange transaction will be respected. However, if there is a withdrawal or surrender within 24 months, then the IRS will "consider all the facts and circumstances to determine whether a partial exchange and subsequent withdrawal from, or surrender of, either the surviving annuity contract or the new annuity contract . . . should be treated as an integrated transaction, and thus whether the two contracts should be viewed as a single contract to determine the tax treatment of a surrender or withdrawal under 72(e)." Thus, if there is a surrender or withdrawal within 24 months, the contract holder runs the risk that the IRS will challenge the transaction.

Notice 2003-51 is somewhat vague about exactly how the IRS would treat a failed partial exchange. It could essentially ignore the purported exchange and continue to treat the old and new contracts as one contract, with the result that a later surrender or withdrawal from one of the contracts would be treated as a partial withdrawal from this single, integrated contract. Or, it could treat the purported exchange as simply a partial withdrawal, taxable immediately at the time of the exchange. The issue of how to treat a failed partial exchange attracted much debate within the insurance industry.

Notwithstanding the foregoing, Notice 2003-51 provided exceptions to this 24-month rule. Specifically, a surrender or withdrawal within 24 months would not be challenged by the IRS as a tax avoidance device if (i) one of the conditions of section 72(q)(2) or any other "similar life event, such as a divorce or the loss of employment" occurs after the partial exchange and before the surrender or withdrawal, *and* (ii) the surrender or distribution was not contemplated at the time of the partial exchange. Section 72(q) lists 10 situations in which a withdrawal from an annuity contract will not be subject to the 10 percent penalty tax. One of the most important situations is a distribution that occurs on or after the date that the taxpayer attains age $59^1/_2$.[11] Other situations exempt from the penalty tax include distributions on account of disability or death.[12] Finally, two other situations warrant mention: the penalty tax does not apply to a distribution (i) that is "a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,"[13] or (ii) under an immediate annuity contract (within the meaning of section 72(u)(4)).[14]

What did this all mean? In very general terms, Notice 2003-51 created a safe harbor: if the taxpayer could keep all the money in the contracts for at least two years after the partial exchange, then the partial exchange would not be challenged as a tax avoidance device. If that is not possible, then Notice 2003-51 offered the taxpayer a way to rebut a presumption of tax avoidance: the partial exchange would still be respected if amounts are withdrawn subsequent to the occurrence of a section 72(q)(2) event or "life event," provided the distribution was not contemplated at the time of the partial exchange. Presumably the "no-contemplation" prong of this test was meant to ensure that the partial exchange was not being used to avoid the income-first rule of section 72(e)(4)(C), while the section 72(q)/"life event" prong was aimed at evasion of the section 72(q) penalty tax. Unfortunately, this two prong rebuttal proved impractical. One reason why was the requirement in Notice 2003-51 that the distribution in all events could not have been "contemplated" at the time of the partial exchange. This "no contemplation" rule seemed to inject a highly subjective, state-of-mind standard, which was difficult for insurance companies to monitor and police as a practical matter, and as a result, reliance on this two-prong rebuttal was too uncertain and risky for many.

So what happens if there is a surrender or withdrawal within 24 months and the section 72(q)(2)/"life event" exception is inapplicable? Notice 2003-51 states that the IRS will rely on general tax principles and examine all the facts and circumstances in order to determine whether to integrate the two contracts. It is an open question just how far the IRS could go in pursuing integration in reliance on general tax principles.

This "no contemplation" rule seemed to inject a highly subjective, state-of-mind standard, which was difficult for insurance companies to monitor and police as a practical matter. …

Taxpayers and insurance companies struggled to apply Notice 2003-51, and even partial exchange transactions that passed muster under Notice 2003-51 were not without controversy within the insurance industry.[15]

The reign of Notice 2003-51 lasted about five years. It was superseded earlier this year by Rev. Proc. 2008-24, which is addressed in the following section.

Rev. Proc. 2008-24

1. In General

On March 13, 2008, the IRS released Rev. Proc. 2008-24, superseding Notice 2003-51. Rev. Proc. 2008-24 represents a significant development in the evolution of the taxation of partial exchanges.

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Rev. Proc. 2008-24 follows the basic approach of Notice 2003-51 of distinguishing between "good" partial exchanges and "bad" partial exchanges based on whether and when the taxpayer tries to take money out of either the old or the new contract. However, Rev. Proc. 2008-24 makes several important changes and clarifications.

First, and perhaps most significant, the 24-month time period in Notice 2003-51 is shortened to 12 months. Thus, so long as there is no withdrawal from, or surrender of, either the old or the new contract within 12 months of the "date of transfer,"[16] the transaction will be respected as a valid tax-free section 1035 exchange. This means that the two contracts will be treated for tax purposes as two separate contracts; they will not be aggregated and treated as one contract.[17] Thus, the taxation of any subsequent withdrawal or surrender of either contract will be determined solely by reference to the income on the contract under each separate contract.

Second, even if there is a withdrawal or surrender within 12 months of the partial exchange, as under Notice 2003-51, the partial exchange will still be respected as a valid section 1035 exchange if a certain type of intervening event occurs. The type of event is one of certain situations listed in section 72(q)(2) or a "life event" (*e.g.*, divorce or loss of employment).[18] This follows the path blazed by Notice 2003-51. However, Rev. Proc. 2008-24 departs from Notice 2003-51 in two respects. First, the taxpayer cannot rely on the conditions in either section 72(q)(2)(D) (substantially equal periodic payments for life) or section 72(q)(2)(I) (an immediate annuity). This change relates to the issue of partial annuitization, which is discussed separately below. Second, Rev. Proc. 2008-24 dispenses with the overriding requirement of Notice 2003-51 that in order to qualify for the section 72(q)(2)/"life event" exception, distributions from the contract must not have been "contemplated" at the time of the partial exchange. Thus, if a qualifying section 72(q)(2) situation or a "life event" occurs, subsequent distributions within the initial 12-month period are permissible under Rev. Proc. 2008-24, apparently regardless of the fact that the taxpayer specifically contemplated that such distributions would occur when he or she entered into the partial exchange.

Third, Rev. Proc. 2008-24 clarifies what the tax consequences are if a partial exchange does not qualify as a tax-free exchange under section 1035, *i.e.*, distributions from either contract occur within 12 months of the partial exchange and the exception for the occurrence of a section 72(q)(2)/"life event" is inapplicable. Under Notice 2003-51, the IRS would examine the facts and circumstances of each case and determine whether under general tax principles the two contracts should be integrated and treated as one. This facts and circumstances test based on general tax principles was a little vague and somewhat impractical to administer, and Rev. Proc. 2008-24 jettisons this approach. Instead, if the terms under Rev. Proc. 2008-24 for obtaining section 1035 treatment are not met, the partial exchange will be treated as a taxable distribution of cash to the contract holder followed by a payment of the cash over to the insurance company for the second annuity, *i.e.*, as a partial withdrawal. Thus, the IRS has decided not to follow the alternative approach of treating the exchange as a nullity and continuing to treat the old and new contracts as one integrated contract.

Finally, Rev. Proc. 2008-24 clarifies that if a partial exchange otherwise qualifies as a tax-free section 1035 exchange under the terms of the Rev. Proc., the IRS will not aggregate the old and new annuity contracts pursuant to section 72(e)(12) or otherwise, even if both contracts are issued by the same insurance company.[19] Rather, as noted above, the two contracts will be treated as separate contracts.

2. Scope and Effective Date

Rev. Proc. 2008-24 applies to any partial exchange transaction, which is defined as the "direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies."[20] Rev. Proc. 2008-24 specifically does not apply to a partial annuitization transaction.[21]

Rev. Proc. 2008-24 is effective for partial exchanges where the cash surrender value transfer is completed on or after June 30, 2008.

3. Issues/Observations/Questions

a. *The 12-month seasoning period*—The 12-month period in Rev. Proc. 2008-24 is a brightline rule. Even if the taxpayer completely surrenders one of the contracts one moment after the 12-month period expires, the partial exchange will be respected. Apparently it does not matter that the taxpayer may have intended, planned or arranged for a surrender of, or withdrawal from, a contract at the time the partial exchange was undertaken. All that matters is that 12 months have expired before the withdrawal event occurs. Like any bright-line rule, the 12-month rule has the benefit of providing certainty and ease of administrability, but at the cost of some arbitrariness.

If a taxpayer does wait out the 12-month period before taking some type of distribution from one of the contracts, the distribution will be taxed by reference to the investment in the contract and the income on the contract for that particular contract without regard to the other contract. The distribution may still be subject to the 10 percent penalty in section 72(q), but the taxpayer can rely on the exceptions under section 72(q)(2) to avoid the penalty. Significantly, the taxpayer can rely on the exception in section 72(q)(2)(D) for substantially equal payments paid out over the taxpayer's life or life expectancy.

b. *The role of intent*—Rev. Proc. 2008-24 drops the "no contemplation" requirement of Notice 2003-51. What should be made of this? Let us return to John's partial exchange transaction in example (2) on page 1. What if, the new ABC contract received in the partial exchange is a type of immediate annuity that commences annuity payments exactly one year and one day after the date of the partial exchange? In this situation, at the time of the partial exchange John has effectively entered into a binding contract to begin receiving payments under the new ABC contract on July 2, 2009. Normally, these facts could raise concerns about the partial exchange being disregarded under general tax principles, such as, for example, the "step transaction" doctrine, and indeed this transaction would have raised serious questions under Notice 2003-51. Does Rev. Proc. 2008-24 change anything?

Maybe it does. Rev. Proc. 2008-24 states unequivocally, and without any kind of qualification, that if John waits for one year before surrendering the ABC contract, "[the partial exchange] will be treated as a tax-free exchange under section 1035" and "the Service will not require aggregation pursuant to the authority of § 72(e)(12), or otherwise, of the [XYZ contract and the ABC contract]."[22] Moreover, Rev. Proc. 2008-24 also says that only if John surrenders the ABC contract one day too early (assuming there is no intervening 72(q)/"life event") will "[the partial exchange] be treated as a distribution, taxable under § 72(e), followed by a payment for the second contract." Taken together, these two statements do not seem to leave the IRS with much wiggle room to challenge John's surrender of the ABC contract a year and day after the partial exchange on step transaction or other grounds. If, and only if, John fails to wait one year will the partial exchange be invalidated. At least, that is what the plain words of Rev. Proc. 2008-24 state. And there is seemingly no reason to take those plain words at anything other than face value, particularly given the fact that Rev. Proc. 2008-24 specifically drops the requirement of Notice 2003-51 that future distributions or withdrawals not be contemplated. As Notice 2003-51 evidences, the IRS knows how to reference "general principles of tax law" when it thinks they should be relevant to the analysis of a partial exchange, and Rev. Proc. 2008-24 clearly has no such qualification or caveat.

While there may be understandable hesitancy about interpreting Rev. Proc. 2008-24 in the foregoing manner, this reading is nevertheless defensible and reasonable, when one understands that Rev. Proc. 2008-24 is creating a brightline rule for both the IRS and taxpayers to follow. The one-year waiting period cuts both ways. Some "innocent" transactions that occur or would occur within one year may be invalidated, and some "guilty"

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transactions that occur after one year may be permitted. But that is what brightline rules do. Rev. Proc. 2008-24 evidences an entirely reasonable conclusion that the administrative burdens on both taxpayers and the IRS of trying to police partial exchanges under "general principles of tax law" and the vagaries of subjective intent is not justified.

Taxpayers, therefore, are probably well advised to avoid transactions that might be vulnerable to a sham transaction challenge.

Notwithstanding the foregoing, would the IRS try to challenge a partial exchange that fully complies with Rev. Proc. 2008-24 as lacking economic substance and any independent business purpose beyond the avoidance of tax, and on that basis seek to have it disregarded as a sham? Probably yes—in cases that the IRS considered particularly egregious. Taxpayers, therefore, are probably well advised to avoid transactions that might be vulnerable to a sham transaction challenge.

c. *The section 72(q)(2) exceptions*—If a distribution from one of the contracts occurs within the 12-month period, the partial exchange will be respected as a valid section 1035 exchange only if one of the permitted exceptions under section 72(q) or a "life event" occurs "between (i) the date of the transfer, and (ii) the date of the withdrawal or surrender." Rev. Proc. 2008-24 is thus fairly specific about the time when the event must occur: the particular condition or event has to "occur" after the date of the partial exchange. There is some reason to question whether this is what was actually intended. For example, one section 72(q)(2) exception specifically referenced in Rev. Proc. 2008-24 is the exception in section 72(q)(2)(F) for distributions "allocable to investment in the contract before Aug. 14, 1982." The event, here, is the investment of premiums in an annuity contract before Aug. 14, 1982, which by definition will have occurred before the date of any partial annuity exchange subject to Rev. Proc. 2008-24. This apparent conflict could be resolved by interpreting "occurred between" as including section 72(q)(2) events that either actually occur between the relevant dates or that are "in existence between" those dates.

The "occurred between" issue is particularly significant with respect to the exception in section 72(q)(2)(A) for distributions on or after the date the taxpayer attains age $59\frac{1}{2}$. Rev. Proc. 2008-24 literally states that only taxpayers who attain age $59\frac{1}{2}$ after the partial exchange date could rely on the age $59\frac{1}{2}$ exception, whereas taxpayers who attained age $59\frac{1}{2}$ before that date could not. If one believes that attainment of age $59\frac{1}{2}$ should be a critical factor in deciding whether distributions are permitted, as Rev. Proc. 2008-24 clearly does, then it does not seem to make much sense to deny the benefit of this exception to taxpayers that attain age $59\frac{1}{2}$ before the partial exchange date.

However unintended and questionable the "occurred between" requirement may be, it is difficult to see how the words can be interpreted in a way that avoids the problem. Probably further, formal clarification from the IRS on this issue is necessary. And indeed, at this time, the insurance industry is actively pursuing such clarification.

d. *Indirect exchanges*—Rev. Proc. 2008-24 applies to "direct transfers" of cash surrender portions, which in this context means the funds go directly from one contract into the other. Thus, Rev. Proc. 2008-24 precludes from its scope so-called "indirect" transfers, where a check is issued to the taxpayer, who then endorses it over in payment for the second contract. This is consistent with the IRS's position that such indirect transfers cannot qualify as a tax-free exchange under section 1035, at least in the case of nonqualified contracts.[23] However, the Tax Court has held that an indirect transfer can qualify as a tax-free section 1035 exchange in appropriate cases.[24] Whatever the status of such indirect exchanges generally under section 1035, they are outside the scope of Rev. Proc. 2008-24.

e. *Effective date*—As noted above, Rev. Proc. 2008-24 is effective for partial exchange transfers that are completed on or after June 30, 2008. However, Notice 2003-51 is seemingly superseded immediately upon the issuance of Rev. Proc. 2008-24 on March 13, 2008. If that is correct, then it is not entirely clear how a partial exchange should be treated if it occurs after March 13, 2008, when Rev. Proc. 2008-24 was issued, but before its effective date.

What About Partial Annuitizations?

Rev. Proc. 2008-24 specifically excludes from its scope "partial annuitization" transactions, which are also on the current "no ruling" list pending future guidance.[25] The tax stakes involved with partial annuitizations relate to whether the partial annuity payments can be treated as "amounts received as an annuity" for purposes of section 72.[26] If so, then an exclusion ratio can be computed with respect to such payments and based on that ratio a portion of each payment would be excludible from gross income as a return of the holder's investment in the contract. If the payments are not "amounts received as an annuity," then by definition they are "amounts not received as an annuity" and they will be subject to taxation as a series of partial withdrawals.[27]

Rev. Proc. 2008-24 defines a "partial annuitization" as a transaction in which "the holder of an annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis."[28] This definition, by its terms, only encompasses a case where a portion of the cash value of a contract is applied under the terms of that same contract (*e.g.*, a specified settlement option under the contract) to the provision of annuity payments. The transaction occurs all within the confines of a single contract and can be referred to as a "same contract" partial annuitization.

A slightly different approach to achieving a partial annuitization is to have a portion of the cash value of one contract assigned toward the purchase of a separate, single premium immediate annuity contract,[29] either from the same company or a different one. This type of partial annuitization is actually a special type of partial exchange, and as discussed above, this type of transaction is within the literal scope of Rev. Proc. 2008-24. (See the example discussed previously where John exchanges part of his contract for a type of immediate annuity that commences a year and a day after the date of the partial exchange.)

Since Rev. Proc. 2008-24 excludes "same contract" partial annuitizations from its scope, the tax treatment of these transactions remains an open issue. Arguments can be made that under existing law "same contract" partial annuitization payments can qualify as "amounts received as an annuity," but technical issues exist, perhaps the most significant being the definition of the "annuity starting date." These issues have been addressed elsewhere and are beyond the scope of this article.[30] Until future guidance is forthcoming facilitating "same contract" partial annuitizations, taxpayers seeking to partially annuitize their contracts should do so *via* a partial exchange involving the acquisition of a new, second contract from either the same company or a different one. Under Rev. Proc. 2008-24, the partial exchange approach should achieve the desired tax treatment if one of the section 72(q)(2) exceptions (or other "life event") is applicable. The one section 72(q)(2) exception of particular significance here is the exception in section 72(q)(2)(A) for taxpayers who attain age 59½ after the partial exchange date. Alternatively, if the section 72(q)(2)(A) exception is inapplicable, the desired tax treatment can be achieved if the payments under the single premium immediate annuity received in the exchange are scheduled to start no earlier than a year and day after the partial annuity exchange, *i.e.*, by relying on the general 12-month rule in Rev. Proc. 2008-24.

Whither Modified Endowment Contracts?

Rev. Proc. 2008-24 only applies to partial exchanges of annuity contracts, not partial exchanges involving a life insurance contract. However, a certain class of life insurance contracts, so-called "modified endowment contracts" or "MECs,"[31] are taxed in a manner similar to nonqualified deferred annuity contracts. Like an annuity, partial withdrawals from MECs are taxable as ordinary income to the extent of the income on the contract,[32] and any amounts withdrawn from a MEC are potentially subject to a 10 percent penalty that largely tracks section 72(q). Given this similarity in taxation, it may be appropriate for the IRS to issue some form of guidance similar to Rev. Proc. 2008-24 addressing MECs.

As a practical matter, it is probably a relatively unusual situation where someone has purchased a MEC and subsequently desires to undertake a partial exchange. One notable exception, however, relates to life insurance purchased by corporations on the lives of their employees as a funding vehicle for providing employee benefits (*e.g.*, retiree health benefits). This is a common transaction and frequently the policies are all single premium life insurance policies, *i.e.*, MECs. Because these policies are typically all purchased at the same time from the same company, they are all aggregated and treated as a single life insurance policy for purposes of section 72(e).[33] The effect of this aggregation rule, unfortu-

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nately, is that if the employer should surrender one of the policies, the surrender can be treated as a partial withdrawal from a single MEC.[34] Yet sometimes there is a legitimate need to surrender a policy. For example, when an employee separates from service or no longer is entitled to benefits, there may be no longer a need or a desire to retain life insurance on this individual, and indeed, some states give such an employee a right to require his or her employer to terminate life insurance purchased on his or her life. Other business reasons may also arise that make it prudent for an employer to terminate previously purchased life insurance on one of its employees. In these circumstances, where the disposition of the life policy is necessary for independent business reasons, it would be appropriate, for example, to allow the employer to exchange the policy for an immediate annuity contract.[35] These circumstances are analogous to the type of "life event" referenced in Rev. Proc. 2008-24.[36]

Until guidance is issued on exchanges involving aggregated MECs, the tax treatment of such MEC exchanges is unclear.

Conclusion

Rev. Proc. 2008-24 is a positive development and a step in the right direction, but more needs to be done. Hopefully, in the not too distant future the IRS will clarify how the section 72(q)(2) exceptions apply and address the issue of "same contract" partial annuitizations.

An additional issue not addressed by Rev. Proc. 2008-24, which warrants further consideration by the IRS, is partial exchange transactions involving MECs. The IRS should specifically consider expanding the scope of Rev. Proc. 2008-24 to include MECs.

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End Notes

1 The tax treatment of "qualified" annuity contracts is beyond the scope of this article.
2 *See* section 72(e)(2)(B)(i) (the "income first rule"). "Income on the contract" refers to the excess of the cash surrender value of a contract (ignoring surrender charges) over the "investment in the contract." *See* section 72(e)(3)(A). "Investment in the contract," in turn, means premiums or other consideration paid, less any previously untaxed withdrawals. *See* section 72(e)(6).
All section references, unless noted, are to the Internal Revenue Code of 1986, as amended.
3 *See* section 72(q)(1).
4 Section 72(e)(12)(A)(ii). A separate aggregation rule also applies to modified endowment contracts. *See* section 72(e)(12)(A)(i).
5 *See* section 72(e)(12)(B) ("The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of [section 72(e)] through serial purchases of contracts or otherwise.").
6 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi.
7 *See* AOD 1999-016 (Nov. 26, 1999).
8 2003-2 C.B. 355.
9 2003-2 C.B. 361.
10 *See also* PLR 200342003 (July 9, 2003) (applying Rev. Rul. 2003-76).
11 Section 72(q)(2)(A).
12 Section 72(q)(2)(B) & (C).
13 Section 72(q)(2)(D).
14 Section 72(q)(2)(I).
15 *See*, *e.g.,* Letter from Susan Seabrook to Michael Desmond (Treasury Dept.), Mark Smith (Treas. Dept.), and John Glover (IRS), dated Aug. 15, 2007, 2007 TNT 173-25.
16 The "date of transfer" means the date "on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange." Rev. Proc. 2008-24, § 4.01(a).
17 Rev. Proc. 2008-24, § 4.03.
18 Rev. Proc. 2008-24, § 4.01(b).
19 Rev. Proc. 2008-24, § 4.03.
20 Rev. Proc. 2008-24, § 3.01.
21 Rev. Proc. 2008-24, § 3.02.
22 Rev. Proc. 2008-24, § 4.03.
23 *See* Rev. Rul. 2007-24, 2007-21 I.R.B. 1282.
24 *See Greene v. Commissioner*, 85 T.C. 1024 (1985).
25 Rev. Proc. 2008-3, § 5.02, 2008-1 I.R.B. 110 (Jan. 4, 2008).
26 *See* Treas. Reg. § 1.72-2(b)(2) (defining "amounts received as an annuity").
27 *See* section 72(e).

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equal solely because the payments vary on account of (1) certain cost of living adjustments; (2) a benefit increase provided to retired employees; (3) an adjustment due to the death of the employee's beneficiary; or (4) the cessation of a social security supplement." Staff of J. Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 712 (Comm. Print 1986).

[12] 1989-1 C.B. 662.

[13] 2002-2 C.B. 710.

[14] 2004-1 C.B. 526.

[15] A private letter ruling is issued to a particular taxpayer and can be relied upon only by that taxpayer. *See* section 6110(k)(3). However, such rulings are widely regarded as reflecting the view of the Service's National Office on the specific facts as of the time the ruling was issued.

[16] For example, Notice 89-25 required the use of a "reasonable" interest rate assumption in the SEPP methodologies it described, and taxpayers sought rulings to ensure that their assumptions would meet this general standard. A few court cases have addressed similar questions. *See*, *e.g.*, *Farley v. Comm'r,* T.C. Summary Opinion 2003-43 (April 22, 2003) (finding that certain assumed rates in the calculation of SEPPs was not reasonable).

[17] *See* PLR 9146008 (Aug. 8, 1991).

[18] *See* also PLR 9805023 (Oct. 31, 1997). The ruling was issued after PLR 9115041, and concluded that certain partial withdrawals from a deferred variable annuity contract would constitute SEPPs within the meaning of section 72(q)(2)(D). The facts of the ruling stated that the contract owner would make a separate written request for each partial withdrawal, which certainly did not establish a fixed and determinable payment stream like the one the Service concluded was necessary in PLR 9115041.

[19] *See* PLR 200113022 (Dec. 29, 2000); PLR 200115039 (Jan. 18, 2001); PLR 200118057 (Feb. 9, 2001).