Conway v. Commissioner, 111 T. C. 350 (1998)

A direct transfer of a portion of funds from one annuity contract to another can qualify as a nontaxable exchange under Section 1035 of the Internal Revenue Code.

Summary

Conway v. Commissioner involved the tax treatment of a partial exchange of an annuity contract. Dona Conway transferred $119,000 from a Fortis annuity to an Equitable annuity, with $10,000 withheld as a surrender charge. The IRS argued this partial exchange should be taxable, but the Tax Court disagreed, holding that a partial exchange of an annuity contract for another annuity contract qualifies as a nontaxable exchange under Section 1035. The decision was based on the direct transfer of funds and the absence of any requirement in the statute or regulations that the entire contract must be exchanged. This ruling also impacted Conway's tax basis in her home and other deductions, but the key principle established was the nontaxable treatment of partial annuity exchanges.

Facts

In 1992, Dona Conway purchased an annuity contract from Fortis Benefits Insurance Co. for $195,643. In 1994, she requested a transfer of $119,000 from this Fortis annuity to purchase a new annuity from Equitable Life Insurance Co. of Iowa. Fortis debited Conway's account, retained a $10,000 surrender charge, and sent a $109,000 check directly to Equitable. Conway indicated on her Equitable application that the transaction was to be treated as a Section 1035 exchange. Initially, Fortis reported the transaction as taxable on a Form 1099-R, but later clarified it was intended to be a nontaxable exchange.

Procedural History

The IRS audited Conway's 1994 tax return and determined a deficiency, asserting the partial annuity exchange was taxable. Conway challenged this in the U. S. Tax Court. After some issues were settled, the primary issue remained whether the partial exchange qualified as a nontaxable exchange under Section 1035. The Tax Court ruled in favor of Conway, holding the partial exchange to be nontaxable.

Issue(s)

1. Whether a direct transfer of a portion of funds invested in an annuity contract into another annuity contract qualifies as a nontaxable exchange under Section 1035 of the Internal Revenue Code.

Holding

1. Yes, because neither Section 1035 nor the regulations condition nonrecognition treatment upon the exchange of an entire annuity contract, and the funds were

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transferred directly without personal use by the taxpayer.

Court’s Reasoning

The Tax Court focused on the plain language of Section 1035 and the applicable regulations, which require only that the contracts be of the same type and the obligee remain the same person. The court rejected the IRS’s argument that the entire contract must be exchanged, citing no such requirement in the statute or regulations. The court also referenced legislative history indicating Section 1035’s purpose to prevent taxation when taxpayers exchange contracts to better suit their needs without realizing gain. The direct transfer without personal use of funds by Conway aligned with this purpose. The court cited Greene v. Commissioner to support a broad definition of “exchange,” emphasizing that Conway remained in essentially the same position after the exchange. The court also noted IRS Revenue Rulings that treated similar partial exchanges as nontaxable.

Practical Implications

This decision clarified that partial exchanges of annuity contracts can qualify as nontaxable under Section 1035, provided the funds are directly transferred and the taxpayer does not personally receive or use the funds. This ruling impacts how tax practitioners should advise clients on annuity exchanges, emphasizing the importance of direct transfers to avoid taxation. It may encourage more flexibility in annuity planning, allowing taxpayers to adjust their investments without tax consequences. Subsequent cases and IRS guidance have generally followed this interpretation, reinforcing the principle that partial annuity exchanges can be nontaxable under the right circumstances.

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