UNDERSTANDING DISTRIBUTIONS

After a Partial 1035 Exchange

A client may be interested in doing a partial 1035 exchange of an annuity contract, which is a tax-free transfer of a portion of the funds from an existing annuity contract to purchase a new annuity contract as described in Section 1035 of the Internal Revenue Code (IRC). In scenarios in which a client would like to take a portion of nonqualified annuity assets to generate income, partial annuitization via partial 1035 exchange may be an option. Below are the rules to keep in mind for this strategy.

Rules for Partial 1035 Exchanges

Before doing a partial 1035 exchange, it is important that you and your client understand the potential consequences. On October 24, 2011, Revenue Procedure 2011-38 became effective and changed the rules for distributions after partial 1035 exchanges.

The rules are as follows:

- A taxpayer has a 180-day waiting period after a partial 1035 exchange before he or she can take a distribution from either contract.
- The lone exception to the 180-day waiting period applies to a client who decides to annuitize for a period of 10 years or more, or for one or more lives.
- If the rule is not followed, "general tax principles" (defined in Revenue Procedure 2011-38) are applied, and the distribution may be treated as taxable "boot" during an exchange.

25-127
VLQ2440-0325
3/25 E328

Take a Closer Look

To get a better picture of how a partial 1035 exchange works, consider the following hypothetical scenarios.

Your client has an existing variable annuity, Contract A, with a contract value of $100,000 and a cost basis of $50,000. On January 1, the client executes a $50,000 partial 1035 exchange from Contract A to another existing variable annuity, Contract B, with a different provider. As you'll see, the cost basis and growth are moved over proportionately or pro rata.

Contract A: ABC Annuity Company	
Before Exchange	After Exchange
$50,000 basis	$25,000 basis
$50,000 growth	$25,000 growth
$100,000 Total Value	**$50,000 Total Value**

Partial Exchange of $50,000

Existing Contract B: XYZ Annuity Company	
Before Exchange	After Exchange
$40,000 basis	$65,000 basis
$10,000 growth	$35,000 growth
$50,000 Total Value	**$100,000 Total Value**

Let's assume that shortly after the exchange, your client is interested in taking distributions from either Contract A or Contract B.

- The client would have to wait to take a distribution for at least 180 days, unless the client is following the annuitization guidelines previously discussed.
- If the client wishes to ignore the waiting period, there may be adverse tax consequences; the client should consult a tax advisor before proceeding.

It's important for you to make your clients aware that if they need immediate income, careful consideration should be made before initiating a partial 1035 exchange. You should provide detailed information about all potential consequences to your client and discuss whether the exchange would be an appropriate strategy.

Partial Annuitization

On September 27, 2010, former President Barack Obama signed the Small Business Jobs Act of 2010 into law. Among other things, the Act brought to the forefront an individual's ability to partially annuitize nonqualified annuity, endowment, and life insurance contracts effective January 1, 2011.

Partial annuitization results in the cost basis being allocated pro rata between the annuitized portion of the contract and the deferred portion. An exclusion ratio then applies to a stream of annuity payments generated by a portion of a deferred annuity's cash value if the payments are received in either of the following ways:

- For a period of 10 years or more
- During the life of one or more individuals

The next issue, however, is whether or not partial annuitization can be initiated through a partial 1035 exchange.

Sources: Revenue Procedure 2008-24, Revenue Procedure 2011-38, and Internal Revenue Code Section 1035.

Initiating through a Partial 1035 Exchange

The IRS has released several communications providing clarification on the tax treatment of partial annuitization and partial 1035 exchanges into single-premium immediate annuities (SPIAs). Based on the rules mentioned above, here are hypothetical examples on how a partial 1035 exchange can work with partial annuitization.

Scenario 1: What does "partial annuitization" encompass?

Scenario 2: Should your client consider partial annuitization on a nonqualified contract or annuitization after a partial 1035 exchange?

Scenario 1: Partial Annuitization from an Existing Nonqualified Contract	
John Doe **Age 60**	**Nonqualified annuity contract:** • Contract value = $400,000 • Cost basis = $200,000 • Partially annuitize 50% of contract ($200,000) under a "Life with Cash Refund" option • Monthly annuity payments = $1,050.45 • Exclusion ratio = 30.2% ($317.24 per payment)

This example follows the intent of the Small Business Jobs Act with regard to the partial annuitization provision. An annuity contract is held at Company X, and the client decides to keep the contract there but annuitize a portion. He could partially annuitize $200,000 (of which $100,000 would be cost basis) and receive exclusion ratio treatment if he chooses to annuitize for 10 years or more or based on his life expectancy.

Scenario 2: Annuitization after a Partial 1035 Exchange	
John Doe **Age 60**	**Nonqualified annuity contract:** • Contract value = $400,000 • Cost basis = $200,000 • Exchange 50% of contract ($200,000) and annuitize under a "Life with Cash Refund" option • Monthly payments after annuitization = $1,050.45 • Exclusion ratio = 30.2% ($317.24 per payment)

This example illustrates a partial 1035 exchange of the existing annuity contract into a SPIA with another annuity company. The cost basis and exclusion ratio treatment will be the same as Scenario 1. The client may accomplish the goal of continued tax deferral for a portion of the annuity and also generate an income stream with the other annuitized portion.

Because the client is annuitizing under the Life with Cash Refund option, which satisfies the "… for one or more lives…" annuitization requirement under Revenue Procedure 2011-38, the 180-day waiting period is waived and he can immediately begin receiving annuity payments from the SPIA that was funded through a partial 1035 exchange. If the client does not annuitize with a life contingency, he may be subject to an additional 10% federal income tax if younger than age 59½.

Examples above are hypothetical and for illustrative purposes only. Data assumes the purchase of a Pacific Income Provider immediate annuity (non-qualified) by a 60-year-old male with a purchase payment of $200,000 and election of the Single Life with Cash Refund annuitization option. (Contract Form Series: 30-1181, 30-1181OR, 30-2181-13) *Contract Form Series may vary by state.*

Summary

Depending on the circumstances, a partial annuitization may or may not be achieved through a partial 1035 exchange.

Partial Annuitization	
Achieved	If the client annuitizes for a period of 10 years or more, or for one or more lives, then the exclusion ratio treatment would apply and there is no need to wait 180 days to begin taking annuity payments. Please keep in mind that if the client is younger than age 59½ and selects a Period Certain option (10 years or more), the exclusion ratio will apply but the client may still be subject to an additional 10% federal income tax.
Not Achieved	If the client does not follow the annuitization requirements for 10 years or more, or for one or more lives, then the general tax treatment may apply and the client would lose the exclusion ratio treatment.

Getting Started

- Meet with your clients who have deferred annuities.
- Discuss the option to annuitize or partially annuitize (depending on income needs).
- Check with your annuity company to confirm:
  - Whether it supports partial annuitization.
  - How partial annuitization may impact any existing contract guarantees, such as optional beneficiary benefits and living benefits (available for an additional cost).

A beneficiary benefit is referred to as a death benefit in the prospectus.

Guarantees are subject to the claims-paying ability and financial strength of the issuing insurance company.

For more information about distributions,
please contact our Retirement Strategies Group at
RSG@PacificLife.com or (800) 722-2333, ext. 3939.
Annuities.PacificLife.com

25-127

VLQ2440-0325 3/25 E328