Non-Qualified Annuity Aggregation
A Lesson Worth Repeating

A common oversight in trying to meet our clients' planning needs is "forgetting about" Internal Revenue Code Section 72(e) (11) (A) (ii): Aggregation of annuities. Many clients (and their advisors) lose sleep attempting to find creative ways to avoid the tax effects of aggregation on withdrawals from serial deferred annuities. Code section 72(e)(11)(A)(ii) reminds us that in determining the amounts includible in gross income for tax purposes, all deferred annuity policies issued by the same company to the same policyholder in any calendar year are treated as a single annuity policy.

Here is a simple example:
Client A purchases 5 non-qualified deferred annuity policies in 2009 from Fidelity & Guaranty Life Insurance Company. For planning purposes, the client names a different beneficiary on each policy, thinking (wrongly) that this will avoid the aggregation rule. To make things simple, let's assume the investment in each is $50,000. Further, let's assume that two years later each policy has grown in value to be worth $60,000. Sometime after, Client A requests a distribution of $40,000 from one of the contracts purchased two years prior.

The investment (tax cost basis) in each is $50,000, interest earnings in each policy at the time of withdrawal is $10,000, for a total gain of $50,000 in the five policies.

Because the five policies are owned by the same owner and were purchased within the same calendar year from the same company, the values are aggregated to determine the amount of gain considered distributed when a withdrawal is requested. Since the withdrawal of $40,000 is less than the total gain in the five policies, the entire withdrawal is considered taxable. While the full amount was removed from a single contract, under the aggregation rules, the gain is determined on a global (aggregated) basis, not on an individual policy basis. Individual policy basis and gain tracking is effectively ignored.

Note: Neither qualified retirement plans nor immediate annuity policies are subject to the aggregation rules. The aggregation rules apply only to non-qualified deferred annuities as explained above.

The IRS is empowered to issue regulations to prevent avoidance of the rules for amounts not received as annuities through serial purchases of deferred annuity policies. The IRS may also treat combination of split annuities as single policy under the rules necessary to enforce the income tax laws.

If you want your client's wishes to be realized in the most tax-efficient manner possible, it is important that you, the insurance professional, know the applicable tax rules. Then, make sure your clients understand what they're purchasing and how the purchase will be treated if/when a distribution is requested. Selling annuities in a manner that meets the client's objectives and that is most suitable in fitting the client's specific situation is the only way to go. Explaining the pitfalls that aggregated taxation of serial purchases can result in will go a long way in meeting your client's needs.

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