

Here's what drafters of US tax law have been up to lately

Both pertain to annuities and both are important.

Non-Qualified Annuity Aggregation

IR Code 72(e)11 (A)(ii)

All annuities issued by the same insurance company within the same calendar year will be treated as a single annuity when determining what amounts are to be taxed as income. This doesn't prohibit an individual from having multiple policies with one insurer, but let's say two separate NQ policies were issued in 2003 with \$50,000 premiums each, and each have values of \$62,500 today -- gains of \$12,500 each.

If the client now withdraws \$25,000 from ONLY ONE of the two policies, he/she will be taxed on the entire \$25,000 amount. Again, this is only true if both policies were issued by the same company in the same calendar year. What the law requires is that these policies be considered as a single policy for tax purposes even though technically, the client withdrew \$12,500 of gain and \$12,500 of principal. These policies are considered to be of the same "series". Sometimes, you hear of such policies referred to as "serialized annuities".

The warning is this: Red flags should now be waving furiously if such a client wishes to take withdrawals from one of a series of policies which exceed interest earned or if they're annuitizing one of two or more such annuities. In the latter case, the impact would be to lower the exclusion ratio (decrease the tax-free part). This rule has no impact at all on qualified annuities issued by the same insurer in the same calendar year.

Partial Non-Qualified Annuity Exchanges

Revenue Procedure 2008-04

Ever do a PARTIAL 1035(a) Exchange? Planning on doing more? Go ahead--Nothing wrong with partial exchanges, but if your client plans on soon thereafter taking income from either the newly created contract or the original, and IF the newly created policy was issued after June 30, 2008, then be careful when explaining tax treatment to your client.

Specifically, will either policy be withdrawn from, annuitized, or surrendered within 12 months of the date the new policy was issued? (It doesn't matter if the new policy was issued by a different insurance company, by the way.) If the answer is "yes", then the amount transferred into the new policy will be treated as a fully taxable distribution up to the amount of gain in the combined policies. Again, that's ONLY if income is withdrawn within the 12 month time frame from either policy, and ONLY if the partial transfer is completed after 6-30-08.

So, for example, a client has principal of \$100,000 and gain of \$50,000 in an annuity, and transfers half the contract to an annuity issued by either the same, or a different insurance company. Law requires that the two new policies have proportional shares of principal and interest (that's not the new rule, that's a standing rule). In the case of this example, half

the original annuity's value was split out, so the proportionality rule means that each policy must be made up of \$50,000 principal and \$25,000 of gain (\$75,000 total each).

If a year goes by and no income is withdrawn from either annuity, your client has nothing to worry about. But, let's say that the client in the above example takes ANY amount of withdrawal from either policy four months after the partial exchange. Oh Boy!!

The new rule treats the whole partially transferred amount as fully taxable, up to the amount of gain in the combined policies. So, if this client takes a \$5,000 withdrawal from either policy during that first year, be sure to NOT explain that they will be taxed on \$5,000, because when they get a 1099 for a \$50,000 withdrawal, they are going to hate you -- bad. Bad enough to call a lawyer.

It's getting to be a scary world. Yet, keep in mind that you shouldn't worry about withdrawals from the vast majority of annuities that are not the product or result of a partial exchange. And don't worry about withdrawals from partially exchanged annuities, if those withdrawals take place more than a year after the exchange. Also, don't worry if the annuities in question hold qualified funds, as all of this pertains only to Non-Qualified annuities. I suppose you don't even have to worry if the annuity being split has no gain in it because the client had previously withdrawn it all.

That leaves the 3 percent?? of transactions that you do need to think about before answering your client's questions about how the transaction will be taxed. If you consider both the Aggregation and Partial Exchange rules discussed here, we have more reason than ever to tell clients to speak with their accountants. I know -- they're cheap. They don't want to pay for an accountant. But their thrift could be your lawsuit. So as Sgt. Esterhaus so well and repeatedly said, "Let's be careful out there".