

LEAVING BEHIND A NONQUALIFIED DEFERRED ANNUITY

Help Your Clients and Their Beneficiaries Navigate the Wealth Transfer Opportunity

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Nonqualified deferred annuities (hereafter, annuities) most often are purchased for the benefits the owner will enjoy during the owner's lifetime. These benefits include tax deferral, investment diversification and/or predictability, future tax-advantaged withdrawals, and future lifetime income.

The entire value of the annuity, however, is not always used up during the owner's lifetime. This means that the beneficiary (or beneficiaries) of the annuity inherit(s) some value from the annuity when the owner dies. It is important to know what beneficiaries may do with what they inherit from an annuity so they can make the most of the inheritance.

Annuity Inheritance Rules

Section 72(s) of the Internal Revenue Code provides the general rules for how a beneficiary must inherit an annuity at the death of the owner. These include the following:

Five-year rule. This rule creates a default option for all beneficiary types (people or entities) that inherit a deferred annuity.¹

One-year rule. This rule is applicable only when a person is the beneficiary of the annuity. This is also known as the life expectancy option.²

Spousal takeover rule. This rule is applicable only when a spouse is the beneficiary and allows a surviving spouse to take over the ownership of the annuity at the death of the first spouse.³

At a basic level, these rules require that when the owner dies, a beneficiary must begin taking distributions from an inherited nonqualified deferred annuity under either the five-year rule or one-year rule, unless the beneficiary is a surviving spouse.

Some other important income tax rules to consider are the following:

- Distributions of gains from inherited deferred annuities are taxed as ordinary income to beneficiaries, unless the beneficiary is a charity.⁴
- Distributions from inherited deferred annuities come from gains first, then from cost basis.⁵
- Distributions taken by beneficiaries from annuities are not subject to the 10-percent tax for premature distributions, even if the beneficiary is under age 59½, because the owner has died.⁶

Finally, there are estate-administration and estate-tax implications with regard to inherited annuities as well. These include the following:

- Annuities that have a beneficiary named on the policy, other than the estate, do not pass through the probate process.
- Annuities owned by an individual, or that individual's revocable trust, are included in the owner's estate for estate-tax purposes.⁷
- If the annuity owner is an estate-tax payer, the beneficiary may utilize the income in respect of a decedent (IRD) income-tax deduction to lessen the

income-tax burden of the forced distributions that must occur due to the death of the owner.⁸

- Annuities do not receive a step-up in basis at the death of the owner.⁹

Now let's look at the specific annuity inheritance rules in more detail.

Five-Year Rule

The five-year rule can be either a choice by the beneficiary or a default option, depending on circumstance and the type of beneficiary.

If a nonspouse person is the beneficiary of an annuity, that person may choose to use the five-year rule or choose to use the one-year rule (explained below). If the nonspouse beneficiary misses the one-year rule starting timeframe (because the first distribution must be taken within one year of the date of the owner's death¹⁰), the nonspouse beneficiary defaults into the five-year rule. However, if the beneficiary is an entity such as a trust, estate, or charity, the five-year rule is the only option available.¹¹

Note that in terms of the timing of withdrawals, the five-year rule presents only a deadline, not a schedule. That is, the beneficiary must make sure that all the money is taken out of the annuity contract by the fifth anniversary of the owner's death. This means the beneficiary can wait until the fifth anniversary of the owner's death to take out the entire sum; take the entire sum shortly after the owner's death; or stage the withdrawals so that distribution is complete

by the fifth anniversary of the owner's death. In other words, the beneficiary has flexibility within the confines of the five-year rule.

Distributions under the five-year rule will come from gains first and be income taxable to the beneficiary unless a tax-exempt charity is the beneficiary. If the beneficiary is a trust or estate, taxable income from the distribution may be passed through to the ultimate beneficiary of the trust or estate in the same tax year; otherwise the trust or estate will be the taxpayer on the gain distributed.¹²

One-Year Rule

When a nonspouse person (but not a trust or estate) is the beneficiary of an annuity, that person may choose to use the one-year rule instead of the five-year rule. If a non-spouse person beneficiary chooses the one-year rule, then the first required distribution must meet the following requirements:

- The first minimum distribution amount must be taken within one year of the owner's death;¹³ and
- The calculation of the minimum distribution amount must be based on the beneficiary's life expectancy.¹⁴

One-Year Rule: Date of Owner's Death Requirement

The required minimum amount must be taken within one year of the owner's death. Here "one year" means within 12 months from the date of death, not the end of the applicable calendar year. For example, if an annuity owner died on March 15, 2015, and left the annuity to a child, the child would need to take out the minimum required amount by March 15, 2016. If the minimum amount is not withdrawn within 12 months, then the beneficiary defaults into the five-year rule and loses the ability to utilize life expectancy-based payments to satisfy the distribution requirements of the annuity inheritance rules.

One-Year Rule Life-Expectancy Payout Methods

In practice, two payout methods have been developed to implement the life-expectancy

component of the one-year rule. The first is the annuitization method, and the second is the systematic withdrawal over life expectancy method, which is also known as the nonqualified stretch option.¹⁵

Life Expectancy Payout through Annuitization

Annuitization transfers the investment risk from the beneficiary to the insurance company in exchange for a guaranteed income stream. Any available single-life payout option or a term-certain-only option that is shorter than life expectancy may be used by the beneficiary. If an annuitization option is chosen, the beneficiary would be able to utilize exclusion ratio treatment on the distributions. Benefits of using this method include the following:

- During the beneficiary's life expectancy, part of the income payment will be treated as gain and part will be treated as return of basis.¹⁶
- If a life-based annuitization option is chosen and the beneficiary lives beyond life expectancy, the remaining distributions will be treated as 100-percent gain.¹⁷

Once the inherited annuity is annuitized, that election cannot be changed.

Life Expectancy Payout through Systematic Withdrawal—*a.k.a.* Nonqualified Stretch Option

This is similar to the stretch or extended individual retirement account (IRA) concept, where the beneficiary uses their remaining life expectancy to calculate an annual required minimum distribution and then takes a distribution annually from the cash value of the inherited annuity.¹⁸

The systematic withdrawal over life expectancy/nonqualified stretch option might be used for several reasons, including the following:

- Continued tax deferral of the remaining cash value after distributions.
- Market exposure in variable subaccounts if a variable deferred annuity is used as the stretch annuity product.

- Potentially smaller annual income-tax bills when only the required minimum amount is taken as compared to other distribution options such as the five-year rule.

The nonqualified stretch option creates the possibility for the beneficiary to have more money over time through the potential for tax-deferred compound growth that continues in the inherited annuity.

There are a number of important technical details to be aware of with regard to the nonqualified stretch option.

Recall that the first required minimum distribution from a nonqualified annuity must be taken within one year of the annuity owner's death. In each subsequent year, the beneficiary must take at least a life expectancy-based required minimum distribution by December 31 of that year. The beneficiary's initial life expectancy factor is determined using the Internal Revenue Service Single Life Table (the same table used for stretching inherited IRAs). Each subsequent year the life expectancy factor is decreased by one.

The beneficiary is not limited to taking the required minimum amount each year. The beneficiary may take more in any year, up to the entire remaining cash value. The beneficiary, as the owner of this inherited nonqualified annuity, determines the investment options, so the beneficiary bears the investment risk and determines the date of the yearly required distributions. The beneficiary is the taxpayer on the gains of the annuity, and the gains are distributed first. No 10-percent tax is applied to any of the distributions from the inherited annuity because the owner has died.

Multiple beneficiaries each may use their respective remaining life expectancy to calculate required distributions from their respective portions of the inherited annuity. The beneficiary may name a successor beneficiary who can finish taking the required minimum distributions if the initial beneficiary dies before the complete distribution of the annuity's cash value. In this circumstance,

the successor beneficiary continues to calculate the required distributions using the remaining life expectancy of the initial, now-deceased, beneficiary.

Finally, not all annuity carriers permit the systematic withdrawal over life expectancy option for beneficiaries, so advisors and clients should be aware of any carrier limitations before purchasing an annuity that is likely to be left behind.

Spousal Takeover Rule

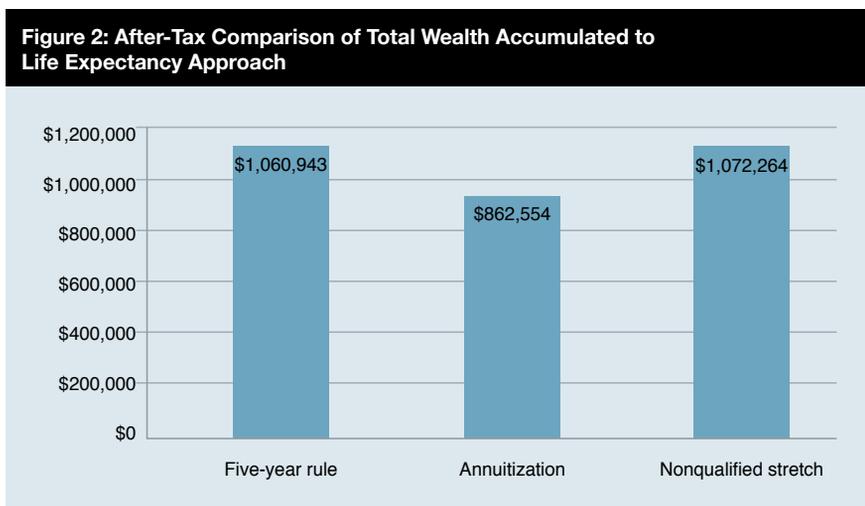
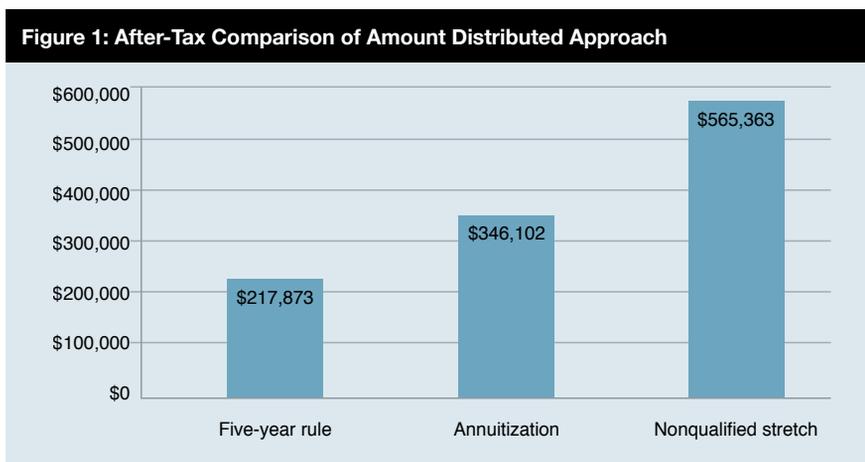
The spousal takeover rule is the most straightforward of the annuity inheritance rules and gives surviving spouses the option to avoid having to take forced distributions.

If a surviving spouse elects to treat the inherited annuity as the surviving spouse's own, the surviving spouse becomes the outright owner of the annuity just as if the surviving spouse had purchased the annuity. The cost basis in the annuity carries over to the surviving spouse, who does not have to take a forced distribution. If the surviving spouse elects to take a distribution, the surviving spouse is responsible for any income tax on the distribution, and the 10-percent tax penalty may apply if the surviving spouse is under age 59½. The surviving spouse may then name a new beneficiary and leave the annuity to another beneficiary under the rules outlined above.

From a practical perspective, if a spousal beneficiary who is under age 59½ inherits an annuity and would like to have access to the funds in the annuity while under age 59½, the surviving spouse may elect the one-year or five-year rule instead of the spousal takeover rule to avoid the 10-percent tax on premature distributions. In doing so, however, the surviving spouse is subject to all the requirements of those distribution rules and is in essence treated as a nonspouse beneficiary.

Comparing Approaches

None of the annuity inheritance options discussed here is inherently better than any other. Each option has its place based on the beneficiary's circumstances. What is seen all too often, however, is that a non-



spouse beneficiary chooses a lump-sum payout soon after the owner's death thinking that this is the only option available. The unfortunate result is often that after-tax money is quickly spent and potentially valuable wealth-building benefits are lost because of a lack of understanding.

So let's look at a comparison of the three nonspouse beneficiary payout options under one specific fact pattern and examine the differences in outcome under each.

Facts

James Fleming purchased a nonqualified deferred annuity when he was 50 years old with \$100,000. James died at age 65. His son Frank Fleming is named as 100-percent beneficiary. The net rate of return is 5 percent for James' accumulation while he is alive, when Frank stretches the annuity, and when the after-tax funds are reinvested.

The pre-tax value at James' death is \$218,287. A 25-percent effective tax rate is applied to the taxable portions of all life-expectancy distributions and annual taxable investment earnings. However, a higher rate of 33 percent is applied to the one-time distribution under the five-year rule because of the larger size of that taxable amount.

Methodologies

After-tax comparison of amount distributed approach. Our first comparison will be of the after-tax amounts distributed from the annuity under each of the distributions approaches: five-year rule, one-year rule annuitization,¹⁹ and one-year rule nonqualified stretch. For the five-year rule a full distribution will occur in the fifth year after James' death, and for the annuitization and nonqualified stretch options distributions will occur annually over Frank's life expectancy and stop at the end of Frank's life

expectancy, which is age 83. For this approach, we also will assume that Frank does not reinvest these funds. Instead he spends them as they are received.

After-tax comparison of total wealth accumulated to life expectancy approach.

Our second comparison will be of the total wealth accumulated at the end of Frank's life expectancy. For this comparison under the five-year rule we will assume a full distribution in the fifth year after James' death, and for the annuitization and nonqualified stretch options distributions will occur annually over Frank's life expectancy and stop at the end of Frank's life expectancy, which is age 83. For each option, once a distribution is taken we will take the after-tax amount of that distribution and deposit it into an annual taxable investment with a return of 5 percent over Frank's life expectancy.

Results Analysis

Under both approaches, the nonqualified stretch option results in the largest amount for Frank, \$565,363 for the first approach and \$1,072,264 for the second approach (see figures 1 and 2). The results of this comparison suggest that more beneficiaries should consider the nonqualified stretch approach regardless of what they intend to do with the money once it is removed from the inherited annuity.

It is also interesting to compare the relatively small difference (\$11,321) between the five-year option and the nonqualified stretch option when the beneficiary reinvests all the after-tax amounts from the inherited annuity versus the significant difference (\$347,490) between the five-year option and the nonqualified stretch option when the beneficiary spends the distributions right away. This is a potent reminder of the wealth-building power of saving versus spending.

The takeaway from this simple example is that more beneficiaries who inherit an annuity should consider utilizing a payout over time approach such as annuitization or nonqualified stretch versus a lump-sum payout, reinvesting as much of the proceeds from the inherited annuity as possible to build more wealth for themselves and their families.

Advisors should make sure to know the payout options that are available to beneficiaries from the annuity companies they work with, and annuity owners should have better conversations with advisors and beneficiaries about their intentions for leaving annuities behind to make sure that valuable wealth-building options are not sacrificed due to lack of knowledge and understanding. ●

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Endnotes

1. See I.R.C. Sec. 72(s)(1)
2. See I.R.C. Sec. 72(s)(2)&(4)
3. See I.R.C. Sec. 72(s)(3)
4. See I.R.C. Sec. 72(e)(2)(B)
5. Ibid.
6. See I.R.C. Sec. 72(q)(2)(B)
7. See I.R.C. Sec. 2039, 2033
8. See I.R.C. Sec. 691(c)
9. See I.R.C. Sec. 1014; Rev. Rul. 79-335, 1979-2 CB 292
10. See I.R.C. Sec. 72(s)(2)(C)
11. See I.R.C. Sec. 72(s)(4)
12. See I.R.C. Sec. 641-685 generally for taxation of trusts and estates
13. See I.R.C. Sec. 72(s)(2)(C)
14. See I.R.C. Sec. 72(s)(2)(B)
15. See Priv. Ltr. Rul. 200151038
16. See I.R.C. Sec. 72(b)
17. Ibid.
18. See Priv. Ltr. Rul. 200151038
19. Annuitization quote from Nationwide Insurance, rates as of December 10, 2015

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