An overview of the nonqualified annuity stretch concept

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KEY HIGHLIGHTS

The beneficiary of a nonqualifed deferred annuity has several payout options and some may create more value over time than others

The nonqualified stretch concept is similar to the extended IRA concept and uses the beneficiary's remaining life expectancy to calculate annual RMDs

A combination of factors can make the nonqualifed annuity stretch advantageous

The nonqualified annuity stretch can potentially grow the proceeds of the inherited annuity and lessen the beneficiaries tax burden

When the owner of a nonqualified deferred annuity dies and leaves the annuity to a nonspouse individual beneficiary that beneficiary has several different distribution options:

- Five-year Rule
- Nonqualified Stretch
- Annuitization

FIVE-YEAR RULE

The five-year rule requires that the entire balance of the annuity be distributed within five years of the date of the owner's death.

The beneficiary may:

- Take all the proceeds soon after the death of the owner
- Take discretionary amounts out at any time during the five-year period
- Wait until the end of the five-year timeframe to take out all the annuity proceeds

Regardless of how the beneficiary chooses to apply the five-year rule, the annuity's gain will be subject to income taxation in the year it is distributed and gains are distributed first.

If a trust, charity or estate is the beneficiary of a nonqualified deferred annuity, the five-year rule is the only distribution option available.

NONQUALIFIED STRETCH, A.K.A. THE LIFE EXPECTANCY METHOD OR ONE-YEAR RULE

This is similar to the stretch or extended IRA concept, where the beneficiary uses his or her remaining life expectancy to calculate an annual required mininmum distribution.

This can be characterized as a systematic withdrawal over life expectancy. A combination of factors may make this option advantageous:

- Growth potential
- Continued tax deferral
- Smaller annual income tax bills if only required minimum amounts are taken
- Access to larger discretionary distributions if needed

Compared to other distribution options like the five-year rule or annuitization, these factors may create more money over time for the beneficiary.

Some important points to consider about the nonqualified annuity stretch payout option are:

- The first required minimum distribution from a nonqualified annuity must be taken within one year of the date 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
- The beneficiary's initial life expectancy factor is determined using the IRS Single Life Table and then one (1) is subtracted from that life expectancy factor for each subsequent year—35, then 34, then 33 and so on
- The beneficiary's age on December 31 of the year following the year of the owner's death is used to determine their initial life expectancy factor
- Each required distribution is determined by dividng the prior year 12/31 contract value by the appropriate life expectancy factor
- The beneficiary is not limited to taking only the required minimum amount; he or she may take more at any time, up to the entire contract value
- The beneficiary, as the owner of this now-beneficial nonqualified annuity, determines the investment options, so they bear the investment risk with this option and determine the date of the yearly required distributions
- The beneficiary is the taxpayer on the gains of the annuity, and the gains are distributed first
- The 10% tax on pre-59 ½ distributions does not apply to any beneficial distributions
- Multiple beneficiaries may each use their own remaining life expectancy to calculate the required distributions (if separate beneficial annuities are created for each beneficiary)
- The beneficial owner may name a successor beneficiary who can finish taking the required minimum distributions if the beneficial owner dies prior to the complete distribution of the annuity's contract value
- The successor beneficiary does not use their own life expectancy, but instead continues to calculate the required distributions using the remaining life expectancy of the original beneficiary
- Not all annuity carriers permit the systematic withdrawal over life expectancy payout option for beneficiaries

ANNUITIZATION

The beneficiary may also annuitize the proceeds of the nonqualified annuity they have inherited. Any available single-life payout option or a term-certain-only option that is not longer than the beneficiary's life expectancy may be used.

Annuitization transfers the investment risk from the beneficiary to the insurance company in exchange for the guaranteed income stream. Also, because this is annuitization, the beneficiary has the benefit of the exclusion ratio treatment on distributions:

- During the beneficiary's life expectancy, part of the income payment will be treated as a gain and part will be treated as return of investment in the contract
- If the beneficiary has chosen a life based payout option and lives beyond his or her life expectancy, then the remaining distributions will be treated as 100% gain

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As you can see, nonspouse individual beneficiaries have many different distribution options with nonqualified annuities. If beneficiaries are looking for ways to potentially grow the proceeds of the annuities left to them and lessen their tax burden on a year-over-year basis, then the nonqualified stretch annuity concept may be an option to consider.

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