W&S Financial Group Distributors
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Understanding Death Benefit Options For Nonqualified (NQ) Annuities

Beneficiaries of NQ deferred annuities generally have multiple death benefit payout options. Availability depends on various factors, including:

- Contract language
- Tax rules regarding when death occurred
- Beneficiary relationship to the deceased

Four Death Benefit Options

1. Lump Sum: This provides immediate access to the entire death benefit. But any and all gain in the contract is taxed to the beneficiary in the year received.

2. Five-Year Deferral: This gives the beneficiary until the fifth anniversary of the date of death of the owner/annuitant to withdraw the death benefit. Partial withdrawals – or a full withdrawal – are permitted throughout the deferral period.

3. Annuitization: This permits the beneficiary to annuitize the contract.[1] Generally, annuitization options can include a fixed period, a fixed amount or a life income option, either life only or life with a period certain.

4. NQ Stretch: This allows non-spouse beneficiaries to take distributions of the annuity death benefit over a period as long as their life expectancy. The first distribution must be taken within one year of the owner/annuitant's death.[1] Distributions must be taken at least annually. The amount of the distribution is generally based on the life expectancy factor using the single life table used for required minimum distributions (RMDs) for qualified plans and IRAs.[2]

Not all carriers offer a NQ stretch option. Some that don't, however, will allow a 1035 exchange to a carrier that does offer the NQ stretch option. As with any 1035 exchange, it's essential the carrier holding the annuity death benefit report the requested distribution/transfer as a 1035 exchange.

Death Benefit Options: Pros and Cons

	Pros	Cons
Lump Sum	Immediate access to cash	All gain includable in income; no continued growth or tax deferral
Five-Year Deferral	Ability to spread any tax over five years; may access cash as needed	All gain must be includable in income within the five-year deferral period
Annuitization	Use of exclusion ratio, each payment is part gain and part return of basis; may elect guaranteed lifetime income	Lack of flexibility and liquidity
NQ Stretch	Allows most flexibility; can stretch payments and taxes over lifetime but can take more as needed[3]	May not qualify for exclusion ratio

1 To avoid inclusion of any lump sum payment offered under the contract, an election to take other than a lump sum payment must be made within 60 days of the date of death.
2 A private letter ruling (PLR) approved three methods for a non-spouse beneficiary to satisfy the lifetime distribution requirements of Code section 72(s): amortization, annuitization, or RMD calculation method. A PLR may not be used as precedent and has no reliance value other than for the particular taxpayer requesting it.
3 Taking more than the required amount will result in the loss of the exclusion ratio and remaining distributions will be taxed under the LIFO (gains first) method.

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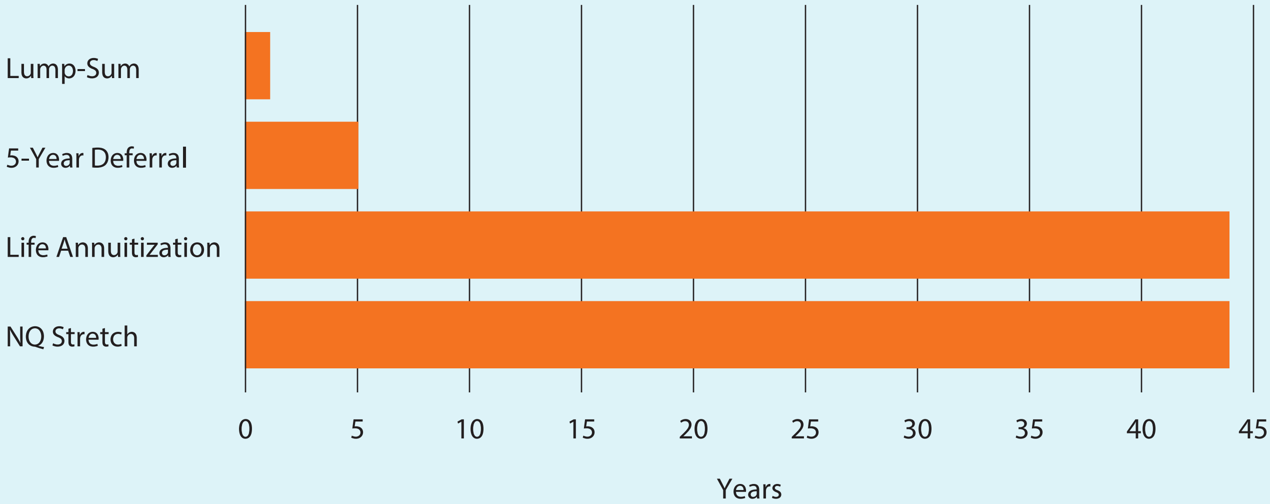
Recognizing Opportunities

Two Forces: Time and Tax-Deferral

Death Benefit Options: Potential Tax-Deferral Durations



When it comes to tax deferral, time can be a force multiplier. When acting in concert, the impact can be powerful.

Consider, for example, the options available to a 39-year-old beneficiary. Life annuitization and NQ stretch options both could potentially spread out income – and taxes – over such a beneficiary's life expectancy of 44.6 years.[1] Note, however, that the NQ stretch option offers greater flexibility than annuitization. Non-spouse beneficiaries not only can stretch over their lifetime, but they also can take more income as needed.

Know More: Consider All Contract Options

It's important to discuss various options available to non-spousal beneficiaries of NQ annuity death benefits. Also, if there is more than one non-spousal beneficiary, most annuity contracts allow each beneficiary to select the option of their choice.

Beneficiaries seeking to grow proceeds of annuities left to them – and lessen their yearly tax burden – may find the NQ stretch option attractive. Still, no one distribution method is best for all. A person's particular tax situation and financial needs must be considered, and the death benefit payout options compared, before taking action.

A Special Rule for Spouses

Is the spouse of the deceased the sole beneficiary? In that case, he or she can generally choose to continue the contract as the successor owner. Doing so allows for continued growth and tax deferral, as well as for the naming of a new beneficiary.

1 Table 1 (Single Life Expectancy; For Use by Beneficiaries); https://www.irs.gov/publications/p590b#en_US_2019_publink1000231236; accessed 9/28/20

For Example

Meet Sarah … Stretching Income and Taxes over Her Lifetime

- Sarah's father was owner and annuitant of a NQ deferred annuity. At his death, its value was $500,000 (with a $250,000 cost basis).
- Sarah is 55 and married. The couple's combined annual taxable income of $100,000 puts them in the 22% federal bracket.
- Her financial professional discusses different distribution options – lump sum, five-year deferral and NQ stretch. The choice could mean tens of thousands of dollars in future value:
  - Assuming all after-tax funds received are reinvested, in15 years the projected future value of NQ stretch account and its distributions total $707,122
  - That's compared to $608,435 with a five-year deferral and $593,388 with the lump sum

	Lump Sum	5-Year Deferral	NQ Stretch		
End of Year	Future Value of Distribution	Account Value + Future Value of Distributions	NQ Stretch Account Value		Future Value of Distributions
Year 1	$434,563	$498,260	$497,601	+	$15,160
Year 5	$475,013	$487,059	$482,635	+	$82,738
Year 10	$530,911	$544,375	$449,989	+	$184,461
Year 15	$593,388	$608,435	$399,994	+	$307,128

All options assume 3% future value/ interest rate. Lump sum distribution assumes 30% combined net effective state & federal tax rate. 5-year deferral distributions assume 27% combined net effective state and federal tax rate. Stretch distributions assume 25% combined net effective state and federal tax rate. All future values of distributions assume 25% combined net effective state and federal tax rate on the growth in future value. Portion of NQ Stretch account value still subject to income tax. Hypothetical results for example only.

Mind the After-Tax Impact

When comparing NQ stretch options, consider the importance of the taxable portion of the required distribution. Required distributions may not always qualify for the exclusion ratio. Taking more than the required distribution will trigger LIFO (gain taxed first) taxation on deferred annuities.

The Exclusion Ratio Difference for Annual Taxes				
End of Year	Account Value	Annual Distribution	Taxable Amount	Net Distribution
Year 1	$515,000	$17,399	$8,953	$15,160
Year 5	$501,864	$19,229	$10,783	$16,533
Year 10	$471,623	$21,634	$13,188	$18,337
Year 15	$423,803	$23,809	$15,363	$19,968

Assumes 3% future value/ interest rate on account value and 25% combined net effective state and federal tax rate on all distributions. Hypothetical results for example only.

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For your NQ stretch needs, consider fixed and immediate annuities from Integrity Life and National Integrity Life.

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