Northwestern Mutual®

Income Taxation of Nonqualified Annuities After Death

After the death of the original owner of a nonqualified annuity, the new owner must start taking distributions and is taxed on gains

Required Distributions

Section 72(s) of the Internal Revenue Code requires distributions from a nonqualified annuity after the death of the owner. If the owner is a non-natural person such as a trust, these rules are triggered by death of the annuitant. These rules are similar to the post-death required minimum distribution rules for IRAs before the changes created by the SECURE act of 2019 (the SECURE act did not change the rules for nonqualified annuities). The rate at which post-death distributions must be made from nonqualified annuities depends on whether the owner dies before or after annuitizing the contract, and who controls the contract after death. The person who controls the contract post-death is usually labeled a "beneficiary" on the contract, but sometimes might be labeled the "successor owner" or some other term.

The rules under §72(s) are summarized in the following chart, but the life insurance company and annuity contract may offer fewer options than what the IRS rules allow.

	Death Before Annuity Starting Date	Death After Annuity Starting Date
General Rule	Entire contract must be distributed within 5 years after death	Distributions must continue at least as rapidly as before death
Exception if beneficiary is individual	Distributions may be stretched over a period not to extend beyond beneficiary's life or life expectancy, but must begin within one year after death	
Exception if beneficiary is spouse	Spouse can keep contract in deferral	If owner dies after annuitization, unclear if spouse can put contract back into deferral
Exception if beneficiary is trust	Analogy to post-death RMD rules for IRAs might permit distributions to be stretched over life of oldest trust beneficiary if (i) trust is valid under state law; (ii) trust is irrevocable or becomes so at death; (iii) all trust beneficiaries are individuals; and (iv) a list of trust beneficiaries is provided to administrator	

Ordinary Income Tax

Distributions of gain from a nonqualified annuity are always taxed at ordinary income tax rates to whomever controls the contract, whether labeled “beneficiary” or “owner” or otherwise.

No Basis Step Up

Nonqualified annuities do not receive a basis adjustment (step-up) at the death of the owner. Unlike a qualified annuity (e.g., in an IRA), a nonqualified annuity generally has basis because after-tax dollars were used to pay for it.

Exclusion Ratio

Non-annuitized withdrawals from nonqualified deferred annuities are taxed gain first, then tax free return of basis. Annuitized distributions from annuities are subject to an exclusion ratio (part tax free return of basis and part ordinary income). If an annuity contract is already annuitized at the owner’s death, the beneficiary’s exclusion ratio depends on the payment plan at the owner’s death, and whether the beneficiary adjusts those payments.

- If the income plan is for a specified period and the beneficiary does not adjust the payments (e.g., does not stretch payments over his life), then the exclusion ratio does not change.
- If the payment plan is life-based with a period certain (e.g., life with 10-year period certain), and the beneficiary does not adjust the payments, the beneficiary first recovers all remaining basis tax-free, and is taxed on any payments thereafter.
- If, however, the beneficiary adjusts the payments so it is possible for the cumulative payments to exceed the guaranteed amount, the beneficiary gets a new exclusion ratio.

No 10% Penalty

There is no 10% penalty for taxable distributions from a nonqualified annuity after death of the annuity’s owner.

IRD Deduction

The value of the annuity is included in the estate of the deceased owner, and the annuity payments taxed to the beneficiary are “income in respect of a decedent” (IRD). The beneficiary is entitled to an income tax deduction for any federal estate tax attributable to the annuity’s IRD portion (i.e., its built-in gain). If no estate tax is due, the beneficiary receives no income tax deduction.

1035 Exchange

In private letter rulings, the IRS has permitted a beneficiary to do a tax free 1035 exchange of an annuity after death of the owner. The contract received in the exchange is still subject to the same post-death RMD rules that applied to the contract that was surrendered in the exchange.

This publication is not intended as legal or tax advice. This information is intended solely for the information and education of Northwestern Mutual Financial Network Representative and the legal and tax advisors with whom they work. It must not be used as a basis for legal or tax advice and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Northwestern Mutual and its Financial Representatives do not give legal or tax advice. Taxpayers should seek advice regarding their particular circumstances from an independent tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.