Northwestern Mutual®

Nonqualified Annuities Overview

Nonqualified annuities have many similarities to those owned by qualified retirement plans or IRAs, but important differences include:

- With nonqualified annuities, it is possible – but usually unwise – to have an owner who is not also the annuitant.
- The terminology and function of nonqualified annuities is not uniform; it can be different from insurance company to insurance company, and contract to contract within an insurance company. (For example, party labeled “beneficiary” does not always take control of contract after death of owner or of annuitant.)

Income tax and nonqualified annuities

Annuities generally have two phases:

- **Accumulation/Deferral:** the time during which the value of the annuity grows tax-free, and
- **Annuitization/Payout Phase/Income Plan:** the time when the annuity pays out under its terms

INCOME TAXATION

ACCUMULATION PHASE

Tax-deferred growth during accumulation phase:

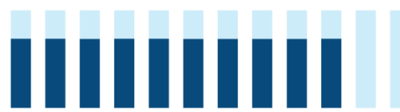
- **Exception: non-natural person rule.** If a non-immediate annuity is held by a non-natural person (e.g., a trust or corporation), annual growth may be taxed depending on the owning entity.
- Non-natural person rule does <u>not</u> apply if contract is held as “agent” for a natural person. Many trust-held annuities likely can meet this exception, but business-held annuities cannot.

Withdrawals are gain-first. First, taxable gain is distributed, then basis is distributed tax-free.

Loans. Borrowing from a contract or even pledging it as collateral is treated as a withdrawal, triggering gain-first taxation.

Gifts trigger income tax. If an individual (human) owner gives a deferral-stage annuity to anyone other than a spouse, donor is taxed on all built-in gain.

ANNUITIZATION PHASE



Exclusion ratio. Payments received “as an annuity” are part tax-free return of basis and part taxable gain. The tax-free portion of each payment is determined by multiplying each payment by the exclusion ratio:

$$\frac{\text{INVESTMENT IN THE CONTRACT (BASIS)}}{\text{EXPECTED RETURN}}$$

Exclusion ratio is applied only until all investment in the contract (basis) is recovered, after which each payment is taxed in full.

Some income tax rules are the same, whether during deferral or during annuitization:

- **Ordinary income tax rates apply**, even if a variable contract.
- **3.8% Net Investment Income Tax applies**, if income over $200,000 if filing single, or over $250,000 if married filing jointly.
- **10% additional penalty tax** can apply during deferral and/or annuitization.
    - Exceptions to the 10% penalty include:
        - Taxpayer over age 59.5;
        - Taxpayer's disability;
        - Series of Substantially Equal Periodic Payments (SOSEPP) over Taxpayer's life;
        - Death of Holder (unless Holder is not an individual (human), in which case it's death of annuitant); and
        - Immediate annuities (note: portfolio immediate income annuities generally do not meet this exception because payments are not "substantially equal").
    - Annuitant is not relevant for penalty exceptions (except for trust-held annuity, and only Annuitant's death).
- **No basis step-up at death.** But the next taker of a "refund" annuity generally receives payments basis-first.

Required minimum distributions (RMDs) and nonqualified annuities

RMDs (Required Minimum Distributions) RMDs triggered by death of contract holder (unless held by a trust, then by annuitant's death)		
	Death **before** annuity starting date	Death **after** annuity starting date
General rule	Entire contract must be distributed in **5 years** after death	Distributions must continue **at least as rapidly** as before death
Exception if beneficiary is individual	Individual (human) designated beneficiary may stretch payments over a period not to extend beyond that **beneficiary's life or life expectancy**, but distributions must **begin within one year after death**. (Note: the SECURE Act of 2019 did not affect RMD rules for nonqualified annuities.)	
Exception if beneficiary is spouse	Spouse designated beneficiary is **treated as the owner**. Similar to rollover for IRAs.	
	Spouse can keep contract in deferral	If owner dies after annuitization, unclear if spouse can put contract back into deferral

The applicable post-death RMD rules do not really depend on who is named "beneficiary," but instead depend on who controls the annuity contract just after the relevant death. This is not always the party labeled "beneficiary" on the contract.

RMDs if post-death beneficiary (controller) of annuity is a TRUST. It might be possible to analogize to IRA rules that permit "looking through" or "seeing through" the trust, to use the oldest individual (human) trust beneficiary (shortest life expectancy) to measure lifetime payments under RMD rules.

General requirements with IRAs:

- trust is valid under state law;
- trust is irrevocable or becomes so at the death of the IRA owner;
- **all trust beneficiaries must be individuals** (as opposed to, say, a charity) as of September 30th of the year after death; and
- list of trust beneficiaries or trust itself is provided to the IRA custodian (e.g., to Northwestern Mutual).

Some insurers, like Northwestern Mutual, permit looking through trusts, as long as trustees represent that they understand the legal uncertainty and trustees represent that the trust qualifies for "look through" treatment.

Be cautious about having a nonqualified annuity owned by a revocable trust.

It introduces ambiguity, without much upside. It is often better to instead use a power of attorney for lifetime management if and when the grantor/owner is incapacitated.

Transfer tax and nonqualified annuities

Gift Tax. The gift tax value of a deferral-stage annuity is its interpolated terminal reserve, which is generally equal to the annuity's accumulation value, but can be lower if surrender charges apply to the contract. The gift tax value of an annuitized contract equals the cost to buy a contract that pays the same annuity stream that remains to be paid after the gift.

Estate Tax. The gross estate includes the value of the annuity that is receivable by a beneficiary by reason of surviving the decedent.

- Value of a deferral-stage annuity is the amount receivable after death, which is usually accumulation value, but can be higher if a "death benefit" provides a greater amount.
- Value of an annuitized contract equals the cost to buy a contract that pays the same annuity stream that remains to be paid on the date of death.

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