

Inheriting a Non-Qualified Deferred Annuities

Take-Away: With the disappearance of defined benefit pensions, many individuals are turning to nonqualified deferred annuities a ‘private’ replacement for those lost pensions. The rules associated with NQDA’s and for those who may inherit them are highly complex and, at times, not all that intuitive.

Background: Normally these missives have not spent much time discussing non-qualified deferred annuities (NQDA) because their accumulation and distribution provisions are governed by each individual contract, which means that NQDA’s are governed by the contract terms and unique policy riders that are selected, and which means annuity contracts widely vary from one to another. Recently what got my attention was the Life Insurance Marketing and Research Association’s 2025 report on the amount that was invested NQDA’s in 2025. The Association reported that \$160.6 billion was invested in multi-year guarantee annuities, and for fixed-indexed annuities the invested amount was another \$128.2 billion. The amounts held in NQDAs may someday be inherited if the annuitant does not survive the annuity’s identified starting date. Inheriting a NQDA leads to some interesting distribution rules under the Tax Code, different from inheriting a traditional IRA.

QLAC: The brief summary that follows on inheriting a NQDA is to be distinguished from a *qualified longevity annuity contract*. A QLAC is funded with pre-tax retirement assets, e.g., a traditional IRA, up to \$210,000. A QLAC is used to minimize an IRA owner’s required minimum distribution (RMD) since the QLAC’s balance is subtracted (more accurately deferred) from the IRA’s December 31 balance that is used to calculate the owner’s RMD for the year. [Regulation 1.401(a)(9)-6, Q&A 17.] Years later, the QLAC must be annuitized. The QLAC is intended to provide the owner of a stream of income for his/her life and is intended to address the fear of a retiree ‘running out of money before death.’

Basis on Death: If the owner of the NQDA dies prior to the annuity’s starting date, the account value will be included in the owner’s gross estate. However, the NQDA does not receive a basis adjustment caused by the owner’s death. Its basis is controlled by the annuity ‘exception’ in the Tax Code. [IRC 1014(b)(9)(A).] Any amounts received by the NQDA beneficiary that exceed the decedent’s investment or basis in the contract are included in

the beneficiary's income and reported as income in respect of a decedent (IRD). [IRC 691(a).] The beneficiary will be entitled to claim an income tax deduction if estate tax was due by reason of the NQDA owner's death. [IRC 691(c).]

Holder's Death Before the Annuity Starting Date: If the holder of the NQDA dies prior to the annuity's starting date, the designated beneficiary faces some interesting distribution rules. If you thought the IRA distribution rules were confusing, welcome to IRC 72! There is the general rule regarding distributions from a NQDA [IRC 72(s)(1)], and another rule that provides an exception to the general rule. [IRC 72(s)(2).]

5-Year Distribution Rule: IRC 72(s)(1)(B) states that when the relevant death is before the annuity's starting date: *"If any holder of such contract dies before the annuity starting date, the entire interest in such contract **will be distributed within five years** after the date of such holder."* [Not the SECURE Act's 10-year distribution rule; this rule is akin to the 5-year distribution rule when there is no designated beneficiary of an IRA.] If the holder of the NQDA contract is not a person, e.g., a corporation or a trust, the 'primary annuitant' will be treated as the holder of the contract. The term 'primary annuitant' "means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract." [IRC 72(s)(6); Only in the Tax Code could we find such an artful use of the words 'primary importance,' but I digress.] The 5-year rule is interpreted to mean that the beneficiary may withdraw from the contract in virtually any pattern, as long as the entire contract value is taken within five years of the relevant death, e.g., a lump sum in year 1, or wait until the 5th anniversary date to take the entire contract value at that time. There is no 10% penalty imposed on the distribution from the NQDA contract, but the gains inherent in the contract's value will be taxed *first* when they are distributed to the beneficiary.

Exception to the 5-Year Distribution Rule: The exception to the 5-year distribution rule is in IRC 72(s)(2). That section provides that: *"If any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary, such portion **will be distributed (in accordance with regulations) over the life of such designated beneficiary** (or over a period not extending beyond the life expectancy of such beneficiary) **and such distributions begin no later than one year after the date of the holder's death**, or such later date as the Secretary may by regulations prescribe."* [This section reads in its entirety- *"If (A) Any portion of the holder's interest payable to (or for the benefit of) a designated*

beneficiary), (B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary, and (C) such distributions begin not later than one year after the date of the holder's death or such later date as the Secretary may by regulations prescribe, then for purposes of paragraph (1) the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distribution begins."

Key Point: The upshot of this exception is that it is best to satisfy its terms due to the tax efficiency in the payout of the NQDA contract to the beneficiary going from five years to possibly a lifetime distribution. For example, if the designated beneficiary of the NQDA contract is the holder's child, he/she may elect to *stretch* payments from the NQDA contract over their life or for a period not longer than their life expectancy, a choice that is not available if the child inherited their parent's IRA.

Exception to the Exception: An 'exception to the exception' is available if the sole designated beneficiary of the NQDA contract is the surviving spouse of the NQDA holder. In this situation, the surviving spouse will be treated as the holder of the NQDA, meaning he/she will be treated as the owner of the NQDA contract. The effect is that the NQDA contract can continue to grow tax deferred, i.e., no payments must leave the contract as they must do for all other designated beneficiaries. The surviving spouse must elect to become the successor owner, which is often referred to as the 'spousal continuation' election. However, as the new owner of the contract, the 10% early distribution penalty before age 59½ may apply to distributions from the contract to the surviving spouse, as well as any 'additional' contract withdrawal charges that the insurance company may impose.

Designated Beneficiary Distribution Options: While the money must leave the NQDA within one year if the designated beneficiary is not the surviving spouse, that beneficiary has the option to annuitize the contract, either selecting the single life payout option, or life with a certain guaranteed period of payout, or any other fixed period payout that is not longer than the beneficiary's remaining life expectancy. If the beneficiary dies while receiving payments and it is within the period certain or fixed period payout option, distributions will then continue to the successor payee. An exclusion ratio is used to calculate the portion of the annuity payments that will be received by the successor payee tax-free (i.e., the return of investment or basis) until the holder's investment in the contract

is exhausted. Thereafter, the distributions will be fully taxable to the beneficiary. No 10% penalty for an early distribution or contractual early withdrawal charges will be imposed. Alternatively, if the beneficiary opts for the *stretch* distribution of the NQDA contract over his/her life expectancy that then will require required minimum distributions (RMDs) determined and redetermined annually.

Death of Holder After the Annuity Starting Date: This is a far less common situation for an individual to inherit a NQDA after the annuity's starting date (which is usually late in life) because the original holder was probably receiving annuity payments from the contract at the time of his/her death. Unless a single life payout option was selected, the Tax Code provides that *"the remaining portion of such interest will be distributed at least as rapidly as under the method of distribution being used as of the date of death.* [IRC 72(s)(1).] Usually, the successor payee under the contract will not have the option to alter the remaining payment schedule.

Conclusion: Tax deferred growth is the name-of-the-game when it comes to NQDA's. Apparently, many individuals are now considering them as a replacement for pensions that are no longer offered by their employers. They are uniquely flexible in light of the various types of contracts, riders, investment options, and duration choices available, which makes any generalization about NQDA's close to meaningless. What is important to remember is to not make assumptions about the distribution rules faced by a designated beneficiary of a NQDA; they are different from those associated with an inherited IRA.

If you would like to read additional missives, [click here](#).