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“What should I do with my inherited annuity?”

By Timothy E. Flatley

With the proliferation of annuities, odds are increasing that you will one day inherit an annuity from a spouse or parent. But there is a significant amount of debate about the investment merits of an annuity, due in large part to the high annual expenses. Below is a condensed guide to the most popular beneficiary options.

The first issue is whether the annuity is a “qualified” or “nonqualified” contract. A qualified annuity is one where the contributions have been made with pretax dollars, resulting in all distributions being taxed as ordinary income. If the beneficiary is the spouse of the annuitant, he or she may roll those distributions into a personal qualified account. Once the spousal beneficiary reaches age 70½, however, he or she must take the required minimum distribution (RMD).

Nonspousal beneficiaries may roll the annuity into an “inherited IRA” account. If the annuitant who passed away was at least 70½, the RMD will have to be taken in the year of death. In the following years, the beneficiary must take an annual RMD based on his or her own life expectancy.

In either case, the death of an annuitant normally will result in any surrender charges being waived for the annuity. This possibility will be based upon the individual situation, as to whether keeping the funds in an annuity or rolling them into a brokerage account for traditional stock, bond, mutual fund, etc., investing makes the most sense. Each beneficiary also has the right to take a full lump sum distribution, but this will result in the maximum tax liability.

Decisions get more complicated when one inherits a nonqualified annuity. **With this category, all premiums were paid with post-tax investment dollars.** Spousal beneficiaries may assume ownership of the annuity and continue tax deferral. Nonspousal beneficiaries also must take distributions via several methods. They may elect an immediate annuity payment stream for a variety of different time periods, typically ranging from five years to lifetime. There will be an exclusion ratio calculated and the earnings portion of each payment will be taxed as income and the remainder considered a return of premium.

Nonspousal beneficiaries may also elect to defer distributions for up to five years. However, the entire annuity must be distributed at some point before the five-year period ends. The deferral option usually entails paying a nominal interest rate during that time. Distributions will be taxed as income until all earnings are withdrawn; then the remainder will be a tax-free return of premium.

Additionally, the annuity may be fully surrendered, resulting in all earnings being taxed immediately. It is important to note that some annuity products have larger payouts depending on the option selected, so be certain to inquire what the lump sum value is, versus the value of a deferred payment. Some annuity companies will offer further options, including the ability to direct the annuity investments while they await distributions.

The decision on how to manage an inherited annuity requires a fair amount of analysis and raises many questions. Over what time frame do you want to receive the distributions? What tax bracket are you in and how will distributions affect it? Do you need a large amount of money immediately? The reasons why the annuity was initially purchased may no longer be valid in your situation, so it is best to take your time evaluating which beneficiary options best suit your goals.

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