

How are inherited annuities taxed?

Written by Lawrence Castillo Guest Columnist
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“It’s fantastic if you inherit an annuity, but you need to understand the tax implications and how to make them more favorable.” – Lawrence Castillo

‘Layin it on the line’

You cannot escape taxes if you inherit an annuity. Fortunately, though, understanding how inherited annuities are taxed can help you avoid paying more in tax than necessary. Your beneficiary status and how the payouts are structured determine tax liability for inherited annuities. You can do a few things to ease that tax burden and perhaps defer payment.

For instance, if you are a surviving spouse inheriting an annuity, you have a few options. You can choose to pay taxes on all the money right now or exercise what is called the “spousal continuation provision.” The spousal continuation provision is a tax strategy you use to avoid paying taxes now. You could also spread your tax payments over time by opting for non-qualified stretch payments based on your life expectancy. All of these options have their pros and cons, and you should always involve your financial or tax advisor in the decision process.

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If you are a non-spousal beneficiary who inherits an annuity, the rules work a bit differently. Still, there are ways to help minimize your tax bill. For example, you could use what's called a bonus annuity to help mitigate your tax burden or choose periodic payments. These types of annuities provide bonus money to incentivize you to purchase them.

You can also use other techniques if you have access to a tax planner. Your planner may recommend what's known as a "1035 exchange," in which you exchange an inherited annuity for a different annuity that is similar but could provide better benefits. The main reason you would even consider doing a 1035 is if a newer annuity offers you better benefits or more favorable terms. The main thing to remember with a 1035 exchange is that you can't swap a qualified annuity for a non-qualified annuity to avoid paying taxes.

If you inherited the deceased annuitant's IRA and the annuity, you might be able to roll the inherited annuity into a personal IRA in your name. The roll-over option is only available to those who inherit both the IRA and annuity. If you could do a roll-over, you would have to follow the inherited IRA tax rules.

QUALIFIED VS. NON-QUALIFIED ANNUITIES

If you want to understand how an inherited annuity is taxed, two terms that are critical to grasp are "qualified" annuities and "non-qualified" annuities. An annuity is qualified if you purchase it with pre-tax dollars via a tax-advantaged account such as an IRA or 401k.

The IRS treats distributions paid to an annuitant from qualified annuities as taxable income in the year they are received. Qualified annuities are also required to follow required minimum distribution rules. Any withdrawals before age 59 ½ may be subject to the 10% early withdrawal

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penalty.

Non-qualified annuities are funded with after-tax dollars in a fashion similar to a Roth IRA. There's a caveat, though. Although contributions to a non-qualified annuity are not taxable, growth and earnings on the initial investment are tax-deferred. Tax-deferred means you will pay ordinary income tax on the earnings portions of your distributions. However, there are no RMD issues, and you won't have that 10% early withdrawal penalty.

Summing it up: An inherited annuity can be a welcome windfall or a potential liability. If you inherit an annuity, be sure you find an expert who can help you navigate the rules and suggest ways to avoid paying more in taxes than you must. The key is in understanding how the IRS treats specific kinds of beneficiaries and annuities.

Lawrence Castillo is a member of *Syndicated Columnists*, a national organization committed to a fully transparent approach to money management.

Lawrence Castillo Host of Safe Money and Income Radio. L and C Retirement Income Planners, 4801 Lang St. NE Suite 100 Albuquerque NM 87109.

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By Lawrence Castillo
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