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Annuity Beneficiary Considerations

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What is an annuity beneficiary?

A named receiver of annuity death benefits

A beneficiary is a person or entity that receives the value of the annuity or annuitization payments that remain (if any) after the death of the annuitant or owner. The annuitant or owner receives annuitization payments during his or her life (the annuitant provides the measuring life for the payments). The beneficiary(ies) is specifically named in the annuity policy. Only the owner of the annuity has the right to name the beneficiary, and he or she may have the right to change the designated beneficiary at any time during the accumulation period (unless the beneficiary designation is irrevocable). When the owner or annuitant dies, the death benefits pass directly to the beneficiary without having to go through the probate process.

Caution: *Some types of annuitization payments end when the annuitant dies and there are no payments available for the beneficiary (e.g., life income annuities). Only certain types of annuitization payments provide for remaining payments that may go to a beneficiary (e.g., life income with term certain annuities).*

Tip: *An annuity beneficiary is similar to the beneficiary of a life insurance policy.*

Under an annuity policy

An annuity policy is a contract between you and the issuer, typically an insurance company. In its simplest form, you pay the company money, they invest it to earn tax-deferred returns, and then they pay the principal plus earnings back to you and/or your beneficiary. What most distinguishes an annuity from retirement plans is that income payments can be guaranteed for a lifetime and there is typically no limit to the amount that can be purchased in a given year. (However, contributions to an annuity do not enjoy the same tax benefits as contributions to qualified retirement plans.)

Technical Note: *This discussion pertains to commercial annuities. It does not pertain to* private annuities *, which are contractual arrangements between private parties.*

What are the beneficiary's rights?

The beneficiary has no rights under the policy except to receive death benefits. However, a beneficiary who has the option to receive death benefits in a lump sum may be able to elect to receive installments instead. In this case, the beneficiary may elect to have the proceeds treated as installments for income tax purposes if the beneficiary elects that form of payment within 60 days after the annuitant's death. If the beneficiary does not make such an election within the period allowed, he or she will be deemed to have received the lump sum and will be taxed accordingly.

How are proceeds received by a beneficiary treated for income tax purposes?

If the owner or annuitant dies before the annuitization starting date

If the beneficiary receives death benefits because the owner or annuitant dies before the annuitization starting date (i.e., without having received any annuity payments), the beneficiary generally receives a death benefit equal to either the accumulated cash value of the policy or the total premiums paid less withdrawals, whichever is greater. The beneficiary will be subject to income tax on the death benefit, to the extent that it exceeds the investment in the contract.

Technical Note: *The annuitization starting date is the first day of the first period in which the owner begins to receive payments under the contract. Thus, if annuitization payments are made each December 31, and if the first annuitization payment will be made on December 31 of Year 1, the annuitization starting date is January 1 of Year 1.*

If the owner or annuitant dies on or after the annuitization starting date.

If the owner or annuitant dies before receiving the guaranteed number of payments based on the annuitization option selected (e.g., on a term certain policy), the beneficiary receives the remaining payments owed. If the beneficiary receives the death benefit as a series of payments, the beneficiary is taxed according to the general annuitization rules (i.e., each payment is part nontaxable principal and part taxable income). If the beneficiary has the option and receives the payment in a lump sum, the payment is treated as nontaxable principal until all the investment is recovered. The excess is taxed to the beneficiary as ordinary income.

Whom should you name as a beneficiary?

Yourself, if you are not the annuitant

If you are the owner but not the annuitant, you may want to name yourself as the beneficiary. The beneficiary receives the death benefits (or continuing annuity payments) when the annuitant dies. Thus, if the annuitant dies before you do, you may want the death proceeds to revert to you. You should consider having a contingent beneficiary in addition to you, the owner, as the primary beneficiary. If you, the owner, die, you may want the death proceeds to go to the contingent beneficiary instead of your estate.

Example(s): *Jack buys a life income with term certain annuity (for 20 years) and names his mother, Jill, as the annuitant and himself as the beneficiary. Jack receives the annuity for 15 years. Jill dies. Jack receives the remaining payments for the next 5 years only.*

Caution: *Tax issues may arise when the owner and annuitant are different people. If the annuitant dies before the owner, the distribution of the annuity may be considered a gift made by the owner subjecting him/her to potential gift tax. Also, the owner may have to include any gain in the annuity as ordinary income. Finally, if the beneficiary is under age 59½ at the time of distribution, the beneficiary may incur a 10 percent early distribution penalty.*

Your spouse

Naming your spouse as the beneficiary has several advantages:

- Your spouse is provided for--Death benefits payable to your spouse provide for his or her welfare.
- No minimum distribution is required--Generally, the death benefit must be paid out to the named beneficiary beginning no later than one year after your (the owner's) death. However, there is an exception to this rule if the sole beneficiary is a surviving spouse. In this case, the surviving spouse may step into the deceased's shoes, become the new owner of the policy, and be permitted to continue the policy with no change.
- The unlimited marital deduction applies--Generally, the amount received by a beneficiary is includable in your (the decedent's) estate for estate tax purposes. However, death benefits payable to a spouse, while included in your gross estate, are not subject to estate tax because they qualify for the unlimited marital deduction .

Example(s): *You should consider having a contingent beneficiary in addition to yourself (the owner) as the primary beneficiary. If you die, you may want the death proceeds to got to the contingent beneficiary instead of to your estate.*

Example(s): *Jack buys a life income with term certain annuity (for 20 years) and names himself as the annuitant and his wife, Jill, as the sole beneficiary. Jack receives the annuity for 15 years. Jack dies, and Jill becomes the new owner of the annuity. Amounts received by Jill are included in Jack's estate for estate tax purposes but are deducted under the unlimited marital deduction.*

Caution: *In* community property *states, you may need your spouse's consent to name someone other than your spouse as the beneficiary of an annuity, particularly if the annuity is purchased with community property funds. Spousal consent is also required with respect to annuities under certain retirement plans.*

Children

You may want to name your children as beneficiaries. However, remember that the beneficiary receives the death benefits when the annuity holder dies. Be aware that if you have purchased an annuitant-driven contract and named your spouse as the annuitant and your spouse dies, your children will receive the death benefits, not you. (This may be a problem if you were depending on the annuity as a source of income.) And if the beneficiaries are under age 59½ they may be subject to a 10 percent tax penalty on the gain.

Minor children

If you name a minor child (under 18) as a beneficiary, you may want to use a trust or appoint an adult to act as a guardian .

Otherwise, if you die while the child is still a minor, the court may have to appoint a guardian. The court's involvement can be costly, time consuming, and intrusive. It's best to avoid it if possible.

Trusts

You need not name an individual as beneficiary; you can also name an entity, such as a trust , as beneficiary. This may be advantageous if the beneficiaries of the trust are minors or spendthrifts (i.e., people who spend money foolishly). However, since a trust is a "nonnatural person" some distribution options may not be available.

Charity

You can name a charitable institution (such as a church, hospital, college, or university) as the beneficiary of your annuity. Generally, the amount received by a beneficiary is includable in your (the decedent's) estate for estate tax purposes. However, death benefits payable to a charity, while included in your gross estate, are not subject to estate tax because they qualify for the estate tax charitable deduction .

How do you name or change (i.e., designate) a beneficiary?

Complete a beneficiary designation form

When you buy an annuity, the insurer will provide you with a form. Generally, the form need only be completed (i.e., name the beneficiaries), signed, and dated by you.

Specifically identify each beneficiary and the distribution he or she is to receive

Be specific when naming the beneficiaries. Make sure the designation clearly identifies to whom the death benefits are to be paid. If you want the death benefits to be distributed to your children (which may include legitimate, illegitimate, or adopted children or children from a previous marriage), specify the name of each child to be sure that the ones you want are included and the ones you don't want are excluded. You may want to include a clause such as "and any afterborn children" to catch any children not yet born.

Tip: *The phrase "to my lawful children" will disqualify illegitimate children.*

Caution: *Terms such as "heirs," "issue," "per stirpes," and "per capita" have legal definitions. Be sure you understand what the terms mean before you use them.*

Specifically revoke previous designations

When changing a beneficiary, it is good to specifically revoke any previous designations (simply write this in on the change of beneficiary form).

Review every two or three years, or upon a change of circumstances

You may want to review your beneficiary designation every two or three years (things change). Additionally, be sure to check and update your designation upon certain life events (e.g., divorce, remarriage, and the birth of children or grandchildren).

Can you change a beneficiary in your will?

A change of beneficiary made in your will does not override the beneficiary designation form. If you want to change the beneficiary, execute a change of beneficiary form. Do not rely on your will to do so.

What if you don't name a beneficiary?

If no beneficiary is named or if there is no living beneficiary, the remaining payments (if any) pass to your estate.

To schedule an appointment with Faye Sykes, click here .

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