INSIGHTS

PACIFIC LIFE

RETIREMENT STRATEGIES GROUP | JULY 2026 RETIREMENT PLANNING/TAX PLANNING

Nonqualified Annuities—Four Key Tax Facts

Nonqualified annuities (NQA) are often considered in retirement planning for their tax deferred growth feature—but do your clients understand common tax implications when they take annuity income? Let's break down what you may need to address.

Annuities offer tax-deferred growth and the potential for lifetime income. They provide income through withdrawals or annuitization, with the latter potentially qualifying for an exclusion ratio under IRC § 72(b) when the annuity is nonqualified. The exclusion ratio means that a portion of the distribution is return of premium, therefore not taxable, and the other portion is taxable interest. Each income option carries its own tax implications that should be carefully weighed alongside the potential benefits.

Four Key Tax Facts to Consider

Clients should be made aware of all of these if they are considering a nonqualified annuity:

1. **Last in, first out:** Remember LIFO—last in, first out—which for NQAs means that earnings are withdrawn before principal and are taxed as ordinary income.
   - Earnings are assessed when a withdrawal occurs, not at year-end. This means if there are earnings in the contract when the withdrawal is taken and the market later drops below the principal or cost basis, the client must still pay taxes on the earnings amount at the time of the transaction.
   - Once clients withdraw all earnings, all remaining annuity income is a return of principal and not taxed.
   - As previously stated, upon annuitization, the exclusion ratio applies, and all payments are only partially taxable. Annuitization also means relinquishing control over the asset. You and your client would want to go over whether this is worthwhile. To retain some control, certain companies may let the client partially annuitize deferred annuities instead of converting the whole contract to income.
2. **Net investment income threshold (NIIT):** This is an additional tax factor that may create confusion.
   - A federal surtax of 3.8% applies to certain types of investment income when a taxpayer's modified adjusted gross income (MAGI) exceeds $200,000 for single or head of household filers and $250,000 for those who use married filing jointly.
   - Distributions of gains from nonqualified annuities are considered net investment income so the 3.8% tax applies if the contract owner exceeds the income threshold. Qualified annuity distributions are not net investment income, but increase income, potentially causing the contract owner to exceed the threshold.
   - When income consists solely of Social Security and retirement account distributions, the surtax would not apply even if MAGI exceeded the thresholds. However, any investment income above that would be subject to the surtax.

While considering whether annuitization is worthwhile may still be a good idea, utilizing the exclusion ratio can be an effective way to maintain income levels with a nonqualified annuity while avoiding the NIIT surtax.

3. **Early withdrawal penalty:** The 10% early withdrawal penalty before age 59½ applies to nonqualified annuities, but only on earnings withdrawn. The 10% penalty does not apply to the withdrawal of principal or cost basis. Clients may mistakenly believe all

withdrawals trigger the penalty. Note: Qualified assets have different and more complex rules and exceptions.

4. **An exclusion ratio and no withdrawal penalties:** A potentially effective strategy for clients seeking early retirement is one that does offer an exclusion ratio to even out paying taxes and will not be subject to the early withdrawal penalty. Clients can purchase a single-premium immediate annuity with cash and begin taking income within a year.
   - That income could be a bridge until they reach age 59½ and gain access to their qualified assets.
   - The income might also bridge a gap until they start taking Social Security retirement benefits.

Nonqualified Annuities Can Be an Important Component of a Retirement Plan

Client satisfaction with nonqualified annuities may be helped by a clear understanding of how they are taxed under varying scenarios. By recognizing how LIFO taxation, NIIT thresholds, early withdrawal penalties, and income strategies like nonqualified SPIAs interact with your client's broader financial picture, you can help avoid unintended consequences and improve after tax outcomes. When used thoughtfully, nonqualified annuities are not just tax deferred vehicles; they can become coordinated planning tools.

ACTIONS YOU CAN TAKE RIGHT NOW

- **Identify pre-retiree and retiree clients who may benefit from tax deferral.**
- **Consider whether a nonqualified annuity, potentially including a SPIA, may be a good fit for these clients.**
- **Evaluate tax implications of withdrawals and annuitization to help determine what best meets the client's situation when it comes time to take income.**

Additional Resources and Links

Nonqualified vs. Qualified Annuities

Additional Uses for Nonqualified Annuities

The Power of Tax Deferral

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.

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