Types of Annuities

There are many different types of annuities and several different methods that are commonly used to classify these annuities. For example, annuities are often distinguished based upon the method of premium payment. Within this classification system there are single premium annuities and deferred annuities. A second classification method looks to the manner in which the annuity’s interest rate is paid. Thus, a fixed annuity pays a set rate of interest while a variable annuity’s interest rate fluctuates.

For income tax purposes, annuities are classified according to the manner in which the contract’s benefits are paid. Thus, in the following paragraphs, are:

1. straight life annuity;

2. single life annuity with refund or period certain guarantee;

3. temporary life annuity;

4. single life annuity with payments increasing or decreasing after a specified period;

5. annuities for two persons acquired for single consideration;

6. joint and survivor annuity – level payments;

7. joint and survivor annuity – level payments with refund or period-certain guarantee;

8. joint and survivor annuity – decreased or increased payments after the first death;

9. joint and survivorship annuity – decreased or increased payments after death of a specified annuitant;

10. joint life annuity;

11. fixed-period option; and

12. fixed-amount option.

# Straight Life Annuity

A straight life annuity is one which provides for fixed payments for the duration of a designated life. Upon the death of the annuitant (i.e., the “measuring life”), no further payments are made, regardless of how few payments have been made.

Types of Annuities

Following are the steps to be taken in computing the excludable portion of each payment under a single life annuity without refund or period-certain guarantee.

1. Determine the investment in the contract.

2. Find the life expectancy multiple in Table I or V of the Annuity Tables, whichever is applicable, for a person of annuitant’s age and sex, if applicable. (Use annuitant’s age on birthday nearest the annuity starting date. If the annuity payments are to be received less frequently than monthly, the Table I or V multiple must be adjusted by use of the Frequency of Payment Adjustment Table.) Multiply the sum of one year’s guaranteed annuity payments by the Table I or V multiple. This is the *expected return* under the contract.

3. Divide the *investment in the contract* by the *expected return* under the contract. Round the quotient off at 3 decimal places and move the decimal point 2 places to the right. This is the exclusion ratio expressed as a percentage (the exclusion percentage).

4. Apply the exclusion percentage to the annuity payment. The result is the portion of the payment that is excludable from gross income. The balance of the payment must be included in gross income. If the annuity starting date is after December 31, 1986, the exclusion percentage applies to payments received only until the investment in the contract is recovered. However, the same exclusion percentage will apply to all payments received throughout the annuitant’s lifetime if the annuity starting date was before January 1, 1987. IRC Sec.72(b)(2).

*Example 1.* On October 1, 1996, Mr. Brown purchased an immediate nonrefund annuity which will pay him $125 per month ($1,500 per year) for life, beginning on November 1, 1996. He paid $16,000 for the contract. Mr. Brown’s age on his birthday nearest the annuity starting date (October 1st) was 68. According to Table V (which he uses because his investment in the contract is post-June 1986), his life expectancy in 17.6 years. Consequently the expected return under the contract is $26,400 (12 × $125 × 17.6). And the exclusion percentage for the annuity payments is 60.6% ($16,000 ÷ $26,400). Since Mr. Brown received 2 monthly payments in 1996 (a total of $250), he will exclude $151.50 (60.6% of $250) from his gross income for 1996, and he must include $98.50 ($250 - $151.50). Mr. Brown will exclude the amounts so determined for 17.6 years. In 1996, he could exclude $151.50; each year thereafter through 2013, he could exclude $909, for a total exclusion of $15,604.50 ($151.50 excluded in 1996 and $15,453 excluded over the next 17 years). In 2014, he could exclude only $395.50 ($16,000 - $15,604.50). In 2014, he would include in his income $1,104.50 ($1,500 - $395.50) and $1,500 in 2015 and in each year thereafter.

Types of Annuities

*Example 2.* If Mr. Brown purchased the contract illustrated above on October 1, 1986, (so that it had an annuity starting date before January 1, 1987), he would exclude $151.50 (60.6% of $250) from his gross income for 1986, and he must include $98.50 ($250 - $151.50). For each succeeding tax year in which he receives 12 payments (even if he outlives his life expectancy of 17.6 years), he will exclude $909 (60.6% of $1,500) and he will include $591 ($1,500 - $909).

The preceding computation is for a straight life annuity (without refund or period-certain guarantee). For a single life refund or period-certain annuity the computation is the same except that an adjustment must first be made to the investment in the contract.

# Single Life Annuity with Refund or Period Certain Guarantee

Under a straight life annuity, the premature death of the annuitant could result in a substantial portion of the annuitant’s basis remaining unrecovered. There are two forms of guaranteed minimum payment annuities which provide protection against this potential risk.

A single life annuity with a *period-certain guarantee* provides for fixed payments for life but also guarantees that a specified minimum number of payments will be made. If the annuitant dies before the guaranteed number of payments have been made, then the remaining guaranteed payments will be made to the beneficiary (commonly referred to as the “refund beneficiary”).

A single life annuity with a *refund guarantee* provides for fixed payments to be made for life but also guarantees (a) to continue the periodic payments until the combined benefits paid to the annuitant and beneficiary equal the purchase price (an installment refund), or (b) to return in cash to the beneficiary the difference between the amount of benefits paid and the purchase price (a cash refund). In the case of a deferred annuity, the purchase price is the cash value of the contract at maturity.

The exclusion ratio for payments under a single life refund or period-certain annuity is determined in the same way as for a straight life annuity with this exception: the *investment in the contract* must first be adjusted by subtracting the value of the refund or period-certain guarantee. The value of the guarantee (the amount which must be subtracted from the investment in the contract) is computed in the following manner:

Types of Annuities

1. Determine the *duration of the guaranteed amount* (the number of years necessary for the total guaranteed return to be fully paid). In the case of a period-certain life annuity, the duration of the guaranteed amount, in years, is known (e.g., 10, 15, 20 “years certain”). To find the duration of the guaranteed amount, in years, for a cash refund or installment refund life annuity, divide the total guaranteed amount by the sum of one year’s annuity payments. Round the quotient to the nearest whole number of years.

2. Enter Table III or Table VII of the Annuity Tables (whichever is applicable, depending on when the investment in the contract is made) with the whole number of years as determined in (1) and the age and (if applicable) sex of the annuitant. This Table III or VII multiple is the *percentage value* of the refund or period-certain guarantee.

3. Apply the Table III or VII multiple to the *smaller* of: (a) the investment in the contract, or (b) the total guaranteed return under the contract. The result is the *dollar value* of the refund or period-certain guarantee.

4. Subtract the dollar value of the refund or period-certain guarantee from the investment in the contract. This *adjusted* investment in the contract is the amount to be used in determining the exclusion ratio for the annuity payments.

*Example 1.* On January 1, 2012, a husband, age 65, purchased for $21,053 an immediate installment refund annuity which pays $100 a month for life. The contract provides that in the event the husband does not live long enough to recover the full purchase price, payments will be made to his wife until the total payments under the contract equal the purchase price. The investment in the contract is adjusted for the purpose of determining the exclusion ratio as follows:

Unadjusted investment in the contract                                             $ 21,053

Amount to be received annually                                                           $ 1,200

Duration of guaranteed amount ($21,053 ö $1,200)                      17.5 yrs.

Rounded to nearest whole number of years                                                 18

Percentage value of guaranteed refund

(Table VII for age 65 and 18 years)                                                 15%

Value of refund feature rounded to nearest dollar

(15% of $21,053)                                                                           $ 3,158

Adjusted investment in the contract ($21,053 - $3,158)               $ 17,895

Once the investment in the contract has been adjusted by subtracting the value of the refund, an exclusion ratio is determined in the same way as for a straight life annuity.

Investment in the contract (adjusted for refund guarantee)          $ 17,895

One year’s guaranteed annuity payments (12 x $100)                      $ 1,200

Life expectancy for Table V, age 65                                                      20 yrs.

Expected return (20 x $1,200)                                                             $ 24,000

Exclusion ratio ($17,895 ÷ $24,000)                                                      74.6%

Amount excludable from gross income each year in which

12 payments are received (74.6% of $1,200)                        $ 895.20

Amount includable in gross income ($1,200 - $895.20)                 $ 304.80

Since the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract; after that has been recovered, the remaining amounts received are includable in income. However, the Small Business Job Protection Act of 1996 (P.L. 104-188) changed the manner in which the unrecovered investment in the contract is calculated for this purpose when the annuity has a refund or guarantee feature. Generally, the portion of any amount received as an annuity that can be excluded using the exclusion ratio is not to exceed the unrecovered investment in the contract. In calculating this figure, the value of the refund or guarantee feature was subtracted prior to the 1996 Act. After the 1996 Act, for this purpose, the value of the refund or guarantee feature is not subtracted. Although this change was made in 1996 legislation, it is effective for individuals with annuity starting dates after December 31, 1986. IRC Sec. 72(b)(4).

*Example 2.* Assume the contract in Example 1 was purchased as a deferred annuity and the pre-July 1986 investment in the contract is $10,000 and the post-June 1986 investment in the contract is $11,053. If the annuitant elects  to compute a separate exclusion percentage for the pre-July 1986 and the post-June 1986 amounts, separate computations must be performed to determine the adjusted investment in the contract. The pre-July 1986 investment in the contract and the post-June 1986 investment in the contract are adjusted for the purpose of determining the exclusion ratios in the following manner:

Types of Annuities

Pre-July 1986 adjustment:

Unadjusted investment in the contract                                                       $ 10,000

Allocable part of amount to be received annually

(($10,000 ÷ $21,053) x $1,200)                                                      $ 570

Duration of guaranteed amount ($10,000 ÷ $570)                                 17.5

Rounded to nearest whole number of years                                                18

Percentage in Table III for age 65 and 18 years                                      30%

Present value of refund feature rounded to nearest dollar

(30% of $10,000)                                                                          $ 3,000

Adjusted pre-July 1986 investment in the contract

($10,000 - $3,000)                                                                          $ 7,000

Post-June 1986 adjustment:

Unadjusted investment in the contract                                             $ 11,053

Allocable part of amount to be received annually

(($11,053 ÷ $21,053) x $1,200                                                       $ 630

Duration of guaranteed amount ($11,053 ÷ $630)                               17.54

Rounded to nearest whole number of years                                                18

Percentage in Table VII for age 65 and 18 years                                    15%

Present value of refund feature rounded to nearest dollar

(15% of $11,054)                                                                          $ 1,658

Adjusted post-June 1986 investment in the contract

($11,053 - $1,658)                                                                          $ 9,395

Types of Annuities

Once the investment in the contract has been adjusted by subtracting the value of the refund, an exclusion ratio is determined in the same way as for a straight life annuity.

Pre-July 1986 investment in the contract

(adjusted for period-certain guarantee)                                      $ 7,000

One year’s guaranteed annuity payments (12 x $100)                     $ 1,200

Life expectancy from Table I, male age 65                                          15 yrs.

Expected return (15 x $1,200)                                                             $ 18,000

Exclusion ratio ($7,000 ÷ $18,000)                                                        38.9%

Post-June 1986 investment in the contract

(adjusted for period certain guarantee)                                      $ 9,395

One year’s guaranteed annuity payments (12 x $100)                     $ 1,200

Life expectancy from Table V, age 65                                                  20 yrs.

Expected return (20 x $1,200)                                                             $ 24,000

Exclusion ratio ($9,395 ÷ $24,000)                                                         39.1%

Sum of pre-July and post-June 1986 ratios                                              78%

Amount excludable from gross income each year in which

twelve payments are received (78% of $1,200)                     $ 936.00

Amount includable in gross income ($1,200 - 936.00)                  $ 264.00

Since the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract; after that has been recovered, the remaining amounts received are includable in income. (Note that 1996 legislation changed the manner in which the unrecovered investment in the contract is calculated for this purpose as explained above in Example 1.)

Types of Annuities

# Temporary Life Annuity

A temporary life annuity is one which provides for fixed payments until the expiration of a specified number of years or until the death of the annuitant, whichever occurs earlier.

To determine the portion of the payments that may be excluded from gross income, an exclusion ratio is computed in the usual manner: the *investment in the contract* is divided by the *expected return* under the contract. However, expected return is determined by multiplying the sum of one year’s annuity payments by a multiple taken from Table IV or Table VIII of the Annuity Tables (whichever is applicable). Table IV or VIII is entered with the age of the annuitant (as of the annuity starting date) and sex (if applicable) and the nearest whole number of years in the specified period. Treas. Reg. §1.72-5(a)(3). (In entering Table IV or VIII, annuitant’s age on birthday nearest the annuity starting date is used. The Table IV or VIII multiple need not be adjusted for payments to be received less frequently than monthly.)

*Example.* Mr. Black, age 60, is to receive $500 per month until the end of 5 years or until he dies, whichever is earlier. The expected return under the contract is $29,400, computed as follows:

One year’s annuity payments (12 x $500)                     $ 6,000

Table VIII multiple for person, age 60, and

term of 5 years                                                                   4.9

Expected return (4.9 x $6,000)                                       $ 29,400

A penalty tax may be imposed on any payments received under a temporary life annuity contract unless one of the exceptions to the premature distribution penalty is met.

# Single Life Annuity with Payments Increasing or Decreasing after a Specified Period

In rare instances, a straight life annuity settlement may provide that the size of the payments will increase or decrease after a specified period.

To find the portion of the payments that may be excluded from gross income, an exclusion ratio is computed in the usual manner: the *investment in the contract* is divided by the *expected return* under the contract. However, expected return is determined as follows:

Types of Annuities

*Decreasing payments.* Compute the expected return for a straight life annuity in the amount of the smaller payment. Compute the expected return for a temporary life annuity in the amount of the difference between the smaller and larger payments. The sum of these two expected returns is the expected return to be used in the exclusion ratio. Treas. Reg. §1.72-5(a)(4).

*Increasing payments.* Compute the expected return for a straight life annuity in the amount of the larger payment. Compute the expected return for a temporary life annuity in the amount of the difference between the smaller and larger payments. Subtract the smaller expected return from the larger. The remainder is the expected return to be used in the exclusion ratio. Treas. Reg. §1.72-5(a)(5).

# Annuities for Two Persons Acquired for Single Consideration

Where annuities for two persons are acquired for a single consideration, a single exclusion ratio must be determined for the whole contract. An expected return is computed separately for each annuitant by using multiples from Table I or Table V of the Annuity Tables (whichever is applicable, depending on when the investment in the contract is made). The investment in the contract is then divided by the sum of these expected returns. The resulting exclusion ratio applies to payments received by each annuitant. Treas. Reg. §1.72-4(e); Treas. Reg. §1.72-5(e). The foregoing treatment applies only to whole life annuities for two people; it does not apply to joint life annuities or joint and survivor annuities.

# Joint and Survivor Annuity: Level Payments

The joint and survivor annuity may be issued as an immediate annuity, or may be payable under a settlement option of endowment maturity proceeds or cash surrender values. In some cases, payments are continued in the same amount to the second payee. In others, at the death of one payee, installments are reduced to three-fourths, two-thirds, or one-half the original amount. Immediate joint and survivor annuities are sometimes issued on a refund or period-certain basis. Optional settlements sometimes provide period-certain guarantees.

This section deals with level-payment joint and survivor annuities without refund or period-certain guarantees.

Types of Annuities

To determine the excludable portion of payments under a level-payment joint and survivor annuity, an exclusion ratio must be computed for the contract as a whole. This is done in the usual way by dividing the total *investment in the contract* by the total *expected return* under the contract. However, in this instance, expected return must be determined by using a joint and survivor life expectancy multiple from Table II or Table VI of the Annuity Tables (whichever is applicable, depending on when the investment in the contract is made). The steps in the computation are as follows:

1. Determine the investment in the contract.

2. Find the joint and survivor life expectancy multiple in Table II or Table VI (depending on when the investment in the contract is made) under the sexes (if applicable) and ages of the annuitants. Multiply one year’s guaranteed annuity payments by the Table II or VI multiple. This is the expected return under the contract.

3. Divide the investment in the contract by the expected return. Round the quotient off at 3 decimal places and move the decimal point 2 places to the right. This is the exclusion ratio expressed as a percentage (the exclusion percentage).

4. Apply the exclusion percentage to the annuity payment. The result is the portion of the payment that is excludable from gross income. The balance of the payment must be included in gross income.

The exclusion ratio as originally determined applies to all payments received under the contract if the annuity starting date was before January 1, 1987: to those received by the survivor as well as to those received while both annuitants are alive. With respect to an annuity with a starting date after December 31, 1986, the exclusion ratio applies to payments received until the investment in the contract is recovered. IRC Sec. 72(b)(2).

*Example.* After June 30, 1986, Mr. White purchases an immediate joint and survivor annuity for himself and his wife. The annuity will provide payments of $100 a month while both are alive and until the death of the survivor. Mr. White’s age on his birthday nearest the annuity starting date is 65; his wife’s, 63. The single premium is $22,000.

Investment in the contract                                         $ 22,000

One year’s annuity payments (12 x $100)                   1,200

Joint and survivor multiple from Table VI

(age 65, 63)                                                                          26

Expected return (26 x $1,200)                                   $ 31,200

Types of Annuities

Exclusion ratio ($22,000 ÷ $31,200)                            70.5%

Amount excludable from gross income each year

in which 12 payments are received (70.5%

of $1,200)                                                                 $ 846.00

Amount includable in gross income

($1,200 - $846.00)                                                      354.00

If the annuity starting date was after December 31, 1986, the total amount excludable is limited to the investment in the contract; after that has been recovered, the remaining amounts received are includable in income.

If the value of the survivor’s annuity was included in the gross estate of the first annuitant, the survivor may also be entitled to a small income deduction for estate tax paid.

# Joint and Survivor Annuity: Level Payments with Refund or Period-Certain Guarantee

Some companies offer immediate joint and survivor annuities on a refund or period-certain basis. And a few companies provide joint and survivor settlement options with a certain period of, for instance, 10 or 20 years.

The exclusion ratio for such payments is determined under the basic rule: total investment in the contract is divided by total expected return under the contract. However, where the contract or settlement provides a refund or period-certain guarantee, the *investment in the contract* must first be *adjusted* by subtracting the value of the guarantee. Treasury regulations (Treas. Reg. §1.72-7(c)) give the method of computing the value of a refund or period-certain guarantee in connection with a level-payment joint and survivor annuity. The steps are as follows:

Investment in the Contract Before July 1986

1. Determine the *duration of the guaranteed amount* (the number of years necessary for the guaranteed amount to be fully paid). In the case of a period-certain annuity, this is the number of years in the guaranteed period (e.g., 10, 15, or 20 “years certain”). To find the duration of the guaranteed amount, in years, for a cash or installment refund annuity, divide the total amount guaranteed by one year’s guaranteed payments, and round the quotient to the nearest whole number of years.

Types of Annuities

2. If the annuitants are not of the same sex, substitute for the female a male 5 years younger (or for the male, a female 5 years older). Then find the refund percentage factors in Table III (of the Annuity Tables) under the number of years as determined in (1) and the age of each annuitant of the same sex. Add these two Table III factors.

3. Using ages of the same sex, as adjusted in (2), add to the age of the older annuitant the number of years indicated in the table below opposite the number of years by which the ages differ.

Addition to

Number of years difference in age (two male   older age

annuitants or two female annuitants)                                         In Years

0 to 1, inclusive                                                                           9

2 to 3, inclusive                                                                           8

4 to 5, inclusive                                                                           7

6 to 8, inclusive                                                                           6

9 to 11, inclusive                                                                         5

12 to 15, inclusive                                                                       4

16 to 20, inclusive                                                                       3

21 to 27, inclusive                                                                       2

28 to 42, inclusive                                                                       1

Over 42                                                                                        0

4. Find the refund percentage factor in Table III under the number of years, as determined in (1) and the age of the older annuitant, as adjusted in (3).

5. Subtract the Table III factor found in (4) from the sum of the Table III factors found in (2). The balance, if any, is the *percentage value* of the refund or period-certain guarantee. If there is no balance, no adjustment to the investment in the contract need be made for the refund or period-certain guarantee. If there is a balance, proceed as follows:

Types of Annuities

6. Apply the *percentage value* of the refund or period-certain guarantee, as determined in (5), to the *smaller* of: (a) the investment in the contract, or (b) the total guaranteed return under the contract. The result is the *dollar value* of the refund or period-certain guarantee.

7. Subtract the dollar value of the refund or period-certain guarantee from the investment in the contract. The remainder is the *adjusted* investment in the contract to be used in determining the exclusion ratio.

*Example.* Mr. Green purchases an immediate joint and survivor annuity for himself and his wife which will pay $200 a month for 10 years certain and as long thereafter as either shall live. Mr. Green is 70 years old as of his birthday nearest the annuity starting date. Mrs. Green in 65. The single premium is $35,000.

Investment in contract (unadjusted)                         $ 35,000

Percentage refund factor from Table III

for male, age 70, and 10-year guarantee                    21%

Percentage refund factor from Table III

for male, age 60, and 10-year guarantee                   11%

Sum of percentage refund factors                                32%

Difference in years of age between two

males ages 70 and 60                                                   10

Addition in years to older age

(see table above)                                                            5

Percentage refund from Table III

for male, age 75, and 10-year guarantee                   29%

**Difference between percentages**                                           3%

Dollar value of period-certain guarantee

(3% of $24,000)                                                                 720

Adjusted investment in the contract                     $34,280

Types of Annuities

After the investment in the contract has been adjusted, proceed:

Investment in the contract (adjusted)                        $34,280

One year’s annuity payments (12 x $200)                     2,400

Joint and survivor multiple from Table II

(male, age 70; female, age 65)                                     20.7

Expected return (20.7 x $2,400)                                  $49,680

Exclusion ratio ($34,280 ÷ $49,680)                                 69%

Amount excludable from gross income

each year in which 12 payments are received

(69% of $2,400)                                                         $ 1,656

Amount includable in gross income

($2,400 - $1,656)                                                           $ 744

If the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract; after that has been recovered, the remaining amounts received are includable in income. However, the Small Business Job Protection Act of 1996 (P.L. 104-188) changed the manner in which the unrecovered investment in the contract is calculated for this purpose when the annuity has a refund or guarantee feature. Generally, the portion of any amount received as an annuity that can be excluded using the exclusion ratio is not to exceed the unrecovered investment in the contract. In calculating this figure, the value of the refund or guarantee feature was subtracted prior to the 1996 Act. After the 1996 Act, for this purpose, the value of the refund or guarantee feature is not subtracted. Although this change was made in 1996 legislation, it is effective for individuals with annuity starting dates after December 31, 1986. IRC Sec. 72(b)(4). Investment in the Contract after June 1986

Where investment in the contract has been made after June 30, 1986, the regulations provide a complex formula for determining the percentage factor developed in the first five steps above with respect to pre-July 1986 investment in the contract. That percentage factor is then applied as explained in steps (6) and (7) above. Reg. §1.72-

Types of Annuities

7(c)(1)(i). The IRS will determine the amount of the adjustment on request. Reg. §1.72-7(c)(4).

# Joint and Survivor Annuity: Decreased or Increased Payments after the First Death

Some joint and survivor annuities, or annuity settlements, provide that the size of the payments will decrease after the first death–regardless of which annuitant dies first (e.g., joint-and-½, joint-and-, or joint-and-¾ survivor annuity). Sometimes, but rarely, the joint and survivor settlement will provide for increased payments after the first death.

The exclusion ratio for such payments is determined in the usual way, by dividing the total investment in the contract by the total expected return under the contract. However, the regulations provide a special method for computing *expected return* (Treas. Reg. §1.72-5(b)(5)). The steps for computing expected return are as follows:

1. Find the joint and survivor multiple in Table II or Table VI (depending on when the investment in the contract is made) under both annuitants’ ages and, if applicable, appropriate sexes. Multiply one year’s annuity payments payable *to the survivor* by this Table II or VI multiple.

2. Find the joint-life multiple in Table IIA or Table VIA (depending on when investment in the contract is made) under both annuitants’ ages and, if applicable, appropriate sexes. Determine the *difference* between the amount of one year’s annuity payments before the first death and the amount of one year’s annuity payments after the first death. Multiply this difference in amount by the Table IIA or VIA multiple.

3. If payments are to be *smaller* after the first death, expected return is the *sum* of (1) and (2). If payments are to be *larger* after the first death, expected return is the *difference* between (1) and (2).

After computing expected return, determine the exclusion ratio under the basic annuity rule: divide the *investment in the contract* by the *expected return* (as computed above). This same exclusion ratio is applied to payments received before the first death and to payments received by the survivor. However, with respect to an annuity having a starting date after December 31, 1986, the exclusion ratio is applied to payments only until the investment in the contract is recovered. IRC Sec. 72(b)(2).

*Example 1:* After June 30, 1986, Mr. Brown buys an immediate joint and survivor annuity which will provide monthly payments of $117 ($1,404 a year) for as long as both he and his wife live, and monthly payments of $78 ($936 a year) to the survivor. As of the annuity starting date he is 65 years old; she is 63. Expected return is computed as follows:

Types of Annuities

Joint and survivor multiple from Table VI

(ages 65, 63)                                                                        26

Portion of expected return (26 x $936)               $24,366.00

Joint life multiple form Table VIA

(ages 65, 63)                                                                      15.6

Difference between one year’s payments before

the first death and one year’s payments

to the survivor ($1,404 - $936)                                     $468

Portion of expected return (15.6 x $468)                   7,300.80

Expected return                                                         $31,636.80

Assuming that Mr. Brown paid $22,000 for the contract, the exclusion ratio is 69.5% ($22,000 ÷ $31,636.80). During their joint lives the portion of each monthly payment to be excluded from gross income is $81.31 (69.5% of $117), or $975.72 a year. The portion to be included is $35.69 ($117 - $81.31), or $428.28 a year. After the first death, the portion of each monthly payment to be excluded from gross income will be $54.21 (69.5% of $78), or $650.52 a year. And $23.79 of each payment ($78 - $54.21), or $285.48 a year, will be included. If the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract. Thus, if Mr. Brown lives for 23 years, he may exclude $81.31 from each payment for 22 years ((12 × 22) × $81.31 = $21,465.84). In the 23rd year he may exclude $534.16 ($22,000 - $21,465.84) or $81.31 from each of the first six payments, but only $46.30 from the seventh. The balance is entirely includable in his income, and on his death, his widow must include the full amount of each payment in income.

*Example 2.* Assume that in the example above, there is a pre-July 1986 investment in the contract of $12,000 and a post-June 1986 investment in the contract of $10,000. Mr. Brown elects to calculate the exclusion percentage for each portion. The pre-July exclusion ratio would be 44.6% ($12,000 ÷ $26,910–the expected return on the contract determined by using Tables II and IIA and the age and sex of both annuitants). The post-June 1986 exclusion ratio is $10,000 ö $31,636.80 or 31.6%.

.

Types of Annuities

# Joint and Survivorship Annuity: Decreased or Increased Payments after the Death of a Specified Annuitant

Some annuities provide that the size of the payments will decrease or increase only if a specified annuitant dies first. For example, the settlement may provide payments of a stipulated amount for so long as the husband lives, but payments of a decreased amount to his wife if she survives him. If the wife dies first, payment will continue in the same amount to the husband until his death.

The exclusion ratio for such payments is determined in the usual way, by dividing the total investment in the contract by the total expected return under the contract. However, the regulations provide a special method for computing expected return (Treas. Reg. §1.72-5(b)(2)). The steps for computing expected return are as follows: 1.Find the joint and survivor multiple in Table II or Table VI (whichever is applicable, depending on when the investment in the contract is made) under both annuitants’ ages and (if applicable) appropriate sexes. Find the single life expectancy multiple in Table I or Table V, whichever is applicable under the age and, if applicable, sex of the first (specified) annuitant. Subtract the Table I or V multiple from the Table II or VI multiple. Then multiply one year’s payments to the second annuitant by the *difference* between the multiples.

2. Multiply one year’s payments to the first annuitant by the Table I or V multiple, whichever is applicable.

3. Add the results of (1) and (2). This is the *expected return* under the contract.

After computing expected return, determine the exclusion ratio under the basic annuity rule: divide the *investment in the contract* by the *expected return* (as computed above).

*Example.* After June 30, 1986, a husband purchases a joint and survivorship annuity providing payments of $100 a month for his life and, after his death, payments to his wife of $50 a month for the remainder of her life. As of the annuity starting date he is 70 years old, and his wife is 67.

Multiple from Table VI (ages 70, 67)                                  22

Multiple from Table V (age 70)                                            16

Types of Annuities

Difference (multiple applicable to second annuitant)                                                                               6

Portion of expected return, second annuitant

(6 x $600)                                                                    $ 3,600

Portion of expected return, first annuitant

(16 x $1,200)                                                               19,200

Expected return under the contract                           $22,800

Assuming that the investment in the contract is $14,310, the exclusion ratio is 62.8% ($14,310 ö $22,800). While the husband lives, $62.80 of each monthly payment (62.8% of $100) is excluded from gross income, and the remaining $37.20 of each payment must be included in gross income. After the husband’s death, the surviving wife will exclude $31.40 of each payment (62.8% of $50), and the remaining $18.60 of each payment will be includable in her gross income. If the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract. Thus, if the husband lives 15 years and receives 180 payments, the unrecovered investment in the contract at his death is $3006 ($14,310 - (180 × $62.80). The surviving wife can exclude $31.40 for 95 payments, and $23 from the 96th payment ($3,006 - (95 × 31.40) = $23). She may exclude nothing thereafter.

The same method is used if payments are to be increased after the death of the first annuitant. Thus, suppose in the example above, payments of $50 a month are to be made for as long as the husband lives, but if he dies first, payments of $100 a month will be made to his wife thereafter. The portion of expected return applicable to the second annuitant would then be $7,200 (6 × $1,200). The portion of expected return applicable to the first annuitant would be $9,600 (16 × $600). And total expected return would be $16,800 ($7,200 + $9,600).

# Joint Life Annuity

A joint life annuity provides for fixed monthly payments to be made only while two annuitants are both alive. In other words, payments will cease upon the first death.

The exclusion ratio for such payments is determined under the basic annuity rule: that is, total *investment in the contract* is divided by total *expected return* under the contract. To compute expected return, however, one year’s annuity payments must be multiplied by a multiple from Table IIA or Table VIA of the Annuity Tables (whichever is applicable,

Types of Annuities

depending on when the investment in the contract is made). Reg. §1.72-5(b)(4). The multiple from Table IIA or Table VIA is obtained under the ages of both annuitants (on birthdays nearest the annuity starting date) and their appropriate sexes, if applicable. If payments are to be received less frequently than monthly, the multiple must be adjusted according to the Frequency of Payment Adjustment Table.

For example, the Table VIA multiple for a person, age 70, and another, age 67, is 13.4. If payments of $100 a month are to be made only while both are still living, expected return is $16,080 (13.4 × $1,200). Fixed-Period Option

The Code provides that payments under a fixed-period option are to be treated as an “annuity” even though no life contingency is involved. Consequently, where living proceeds, such as endowment maturity values or cash surrender values, are payable under a fixed-period option, the basic annuity rule of Code section 72 applies in taxing the payments. That is, the total *investment in the contract* is divided by the total *expected return* under the contract to determine the exclusion ratio for the payments.

Total expected return is computed by multiplying the fixed number of years or months by the guaranteed payment for each such period. Treas. Reg. §1.72-5(c).

For example, suppose that $25,000 of endowment maturity proceeds are to be received in monthly payments over a fixed period of 10 years. If the guaranteed rate of interest is 2-¼%, the monthly payment will be $232.12 ($2,785.44 a year), and expected return will be $27,854.40 (120 × $232.12). Assuming that the investment in the contract is $22,500, the exclusion ratio is $22,500/$27,854.40, or 80.8%. And the amount excludable each year is $2,250.64 (80.8% of $2,785.44). If the payee dies before the guaranteed period expires, his beneficiary will exclude the same portion of each payment as originally computed. Treas. Reg. §1.72-11(c)(2), Ex. 4.

A short-cut method may be used to determine the excludable portion of each year’s payments. Simply divide the investment in the contract by the number of years in the fixed period. The result will usually vary not more than a few cents from the result under the more exact exclusion ratio method. Taking the figures above, for example, the short-cut method would produce a yearly excludable amount of $2,250 ($22,500 ÷ 10).

A penalty tax may be imposed on any payments received under the contract unless one of the exceptions listed is met.

Types of Annuities

# Fixed-Amount Option

As in the case of a fixed-period option, the Code provides that payments under a fixed-amount option are to be treated as an “annuity” – even though no life contingency is involved. The payments are taxed, therefore, by applying the exclusion ratio to the payments. This exclusion ratio is determined, under the basic annuity rule, by dividing the total *investment in the contract* by the total *expected return* under the contract. Expected return, in this instance, is obtained by multiplying the fixed-amount payment by the number of payments which will exhaust principal and guaranteed interest. Treas. Reg. §1.72-5(d). Additional payments, received after principal and guaranteed interest are exhausted – payments due to excess interest – are fully taxable. Treas. Reg. §1.72-11(b)(2).

For example, suppose that $25,000 of endowment maturity proceeds are to be received in fixed-amount payments of $200 a month ($2,400 a year). If the guaranteed rate of interest is 2-¼%, payments of $200 a month will be made for a period of 142 months. Consequently, expected return is $28,400 (142 × $200). And, assuming that the investment in the contract is $22,500, the exclusion ratio is $22,500/$28,400, or 79.2%. Thus, the payee may exclude from gross income each year. $1,900.80 (79.2% of $2,400). Payments received after the 142-month period, however, are fully taxable.

A short-cut method will give a result varying from that of the exclusion ratio method by less than one dollar. Simply divide the investment in the contract by the number of guaranteed payments. Taking the figures above, for example, the short-cut method results in a yearly excludable amount of $1,901.40 ($22,500 ÷ 142 = $158.45; 12 × $158.45 = $1,901.40).

A penalty tax may be imposed on any payments received under the contract unless one of the exceptions listed is met.

# Variable Annuities

Variable annuities differ from fixed-dollar annuities in that the size of the payments is not guaranteed but varies according to investment experience, cost-of-living indices, or similar fluctuating criteria.

Obviously, it would not be feasible, or equitable from a revenue standpoint, to apply the regular annuity rules in taxing such payments. If investment experience were very favorable, for example, the application of a constant exclusion ratio would result in a correspondingly increased tax-free portion.

Types of Annuities

Treasury regulations, therefore, provide special rules for taxing variable annuities. However, for taxable years beginning after December 31, 1983, a variable annuity contract will not be treated as an annuity and taxed under these rules *unless* the underlying investments of the segregated asset account are “adequately diversified,” according to regulations to be prescribed by the IRS. IRC Sec. 817(h). In general, these rules provide that the amount which can be excluded from gross income in a taxable year is the portion of the investment in the contract which is allocable to that year. This is determined by dividing the investment in the contract by a multiple taken from the annuity tables which represents the anticipated number of years over which the annuity will be payable. Treas. Reg. §1.72-2(b)(3). All amounts received in excess of this yearly exclusion are fully taxable. The amount so determined may be excluded from gross income each year for as long as the payments are received if the annuity starting date was before January 1, 1987 (even after the annuitant has outlived his life expectancy and recovered his cost tax-free). In the case of an annuity contract with a starting date after 1986, the amount determined may be excluded from gross income only until the investment in the contract is recovered. IRC Sec. 72(b)(2).

If the annuity is payable for a single life, the investment in the contract is divided by the appropriate life expectancy multiple from Table I or Table V, whichever is applicable (depending on when the investment in the contract is made). The quotient is the amount which may be excluded from gross income in each taxable year.

For example, suppose that a man, age 65, purchases a variable annuity contract for $24,000. To determine the amount he will receive tax-free in each taxable year, his $24,000 investment is divided by 20 (the Table V multiple for a person, age 65). The amount he can exclude from gross income each year, then, is $1,200 ($24,000 ÷ 20). Thus, if he receives $1,850 in a particular taxable year, he must include $650 of that year’s payment in gross income ($1,850 - $1,200).

If the annuity provides a refund or period-certain guarantee, the investment in the contract must first be adjusted by subtracting the value of the guarantee. As in the case of other refund or period-certain annuities, the adjustment is made by application of a percent refund multiple from Table III or Table VII, whichever is applicable (depending on when the investment in the contract is made). Treas. Reg. §1.72-7(d). The appropriate Table III or VII (Use annuitant’s age on birthday nearest the annuity starting date. If payments are to be received less frequently than monthly, an adjustment must be made to Table I or V multiples, according to the Frequency of Payment Adjustment Table. No adjustment for frequency of payment need be made to a Table III or VII multiple.) factor is found under the age and, if applicable, sex of the annuitant and the number of years in the guarantee period. If the contract guarantees that proceeds from

Types of Annuities

so many units will be paid for a fixed number of years and life thereafter, the fixed number of years is the number of years in the guarantee period. But if a specific amount is guaranteed, on a refund basis, the number of years in the guarantee period is determined as follows: The total guaranteed amount is divided by the sum of the payments received for the first taxable year. If payments received in the first taxable year are not for a full taxable year, the amount actually received must be placed on an annual basis. For example, if monthly payments commence in August, the total amount received in the taxable year is divided by 5 and multiplied by 12. The quotient obtained by dividing this amount into the total amount guaranteed, if not a whole number of years, is rounded to the nearest whole number of years.

To find the dollar value of the refund or period-certain guarantee, the Table III or VII percent factor (whichever is applicable) is applied to the *smaller* of the two following amounts: (a) the investment in the contract, or (b) the total guaranteed amount. (In the case of a period-certain annuity, the total guaranteed amount is the product of the payments received in the first taxable year, placed on an annual basis, multiplied by the number of years payments from the units are guaranteed.) This dollar value of the guarantee is then subtracted from the investment in the contract. The following illustration is taken from the regulations (Treas. Reg. §1.72-7(d)(2)):

*Example 1*: Taxpayer A, a 50-year-old male, purchases for $25,000, a contract which provides for variable monthly payments to be paid to him for his life. The contract also provides that if he should die before receiving payments for fifteen years, payments shall continue according to the original formula to his estate or beneficiary until payments have been made for that period. Beginning with the month of September, A receives payments which total $450 for the first taxable year of receipt. This amount, placed on an annual basis, is $1,350 ($450 ÷ 4 or $112.50; $112.50 × 12, or $1,350).

If there is no post-June 1986 investment in the contract, the guaranteed amount is considered to be $20,250 ($1,350 x 15), and the multiple from Table III [for male 50, 15 guaranteed years–Ed.], 9 percent, applied to $20,250 (since this amount is less than the investment in the contract), results in a refund adjustment of $1,822.50. The latter amount, subtracted from the investment in the contract of $25,000, results in an adjusted investment in the contract of $23,177.50. If A dies before receiving payments for 15 years and the remaining payments are made to B, his beneficiary, B shall exclude the entire amount of such payments from B’s gross income until the amounts so received by B, together with the amounts received by A and excludable from A’s gross income, equal or exceed $25,000. Any excess and any payments thereafter received by B shall be fully includable in gross income.

Types of Annuities

Assume the total investment in the contract was made after June 30, 1986. The applicable multiple found in Table VII is 3 percent. When this is applied to the guaranteed amount of $20,250, it results in a refund adjustment of $607.50. The adjusted investment in the contract is $24,392.50 ($25,000 - 607.50).

If investment experience is poor, payments received in one or more taxable years may be less than the annuitant’s allowable exclusion. However, this loss of exclusion need not be permanent; it can be recouped in future years by taking advantage of a special election to re-determine the excludable amount. Treas. Reg. §1.72-4(d)(3). The annuitant may make this election in any succeeding year in which he receives payments under the annuity.

The new excludable amount is determined as follows. The total amount actually received in the years prior to the year of election is subtracted from the total amount excludable for those years under the original determination. The difference is divided by the Table I or Table V life expectancy multiple, whichever is applicable, for annuitant’s age on the first day of the first period for which he receives a payment in the year of election. The quotient so obtained is added to his original annual exclusion. This increased exclusion is then applicable to the year of election and succeeding tax years.

*Example 2:* Taxpayer B, purchases a variable annuity contract which provides payments for life. The annuity starting date is June 30, 1991, when B is 64 years old. B receives a payment of $1,000 on June 30, 1992, but receives no other payment until June 30, 1994. B’s total investment in the contract is $25,000. B’s pre-July 1986 investment in the contract is $12,000. B may re-determine his excludable amount as above, using the Table V life expectancy. If, instead, he elects to make separate computations for his pre-July 1986 investment and his post June-1986 investment, his additional excludable amount is determined as follows.

Pre-July 1986 investment in the contract allocable to tax-

able years 1992 and 1993 ($12,000 ÷ 15.1 [multiple from

Table 1 for a male age 64] = $794.70; $794.70 x 2 years

= $1,589.40)                                                                                              $ 1,589.40

Less: portion of total payments allocable to pre-July 1986

investment in the contract actually received as an annuity

in 1992 and 1993 ($12,000/$25,000 x $1,000)                                          $ 480.00

Types of Annuities

Difference                                                                                                  $ 1,109.40

Post-June 1986 investment in the contract allocable to

taxable years 1992 and 1993 ($13,000 ÷ 20.3 [multiple

from Table V for male age 64] = $640.39; $640.39 x 2

years = $1,280.78)                                                                          $  1,280.78

Less portion of total payments allocable to post-July 1986

investment in the contract actually received as an annuity

in 1992 and 1993 ($13,000/$25,000 x $1,000)                                         $  520.00

Difference                                                                                                   $ 760.78

Because the applicable portions of the total payment received in 1992 under the contract ($480 allocable to the pre-July 1986 investment in the contract and $520 allocable to the post-June 1986 investment in the contract) do not exceed the portion of the corresponding investment in the contract allocable to the year ($794.70 pre-July 1986 and $640.39 post-June 1986) the entire amount of each applicable portion is excludable from gross income and B may re-determine his excludable amounts as follows:

Divide the amount by which the portion of total payment

actually received allocable to pre-July 1986 investment in the

contract in less than the pre-July 1986 investment in the con-

tract allocable to 1992 and 1993 ($1,109.40) by the life

expectancy under Table I for B, age 66 (14.4 - .5 [frequency

multiple]; ($1,109.40 ö 13.9)                                                                           $ 79.81

Add the amount originally determined with respect to pre-

July 1986 investment in the contract                                                           $   794.70

Amount excludable with respect to pre-July 1986 invest-

ment                                                                                                               $ 874.51

Types of Annuities

Divide the amount by which the portion of total payment

actually received allocable to post-June 1986 investment in

the contract is less than the post-June 1986 investment in the

contract allocable to 1992 and 1993 ($760.78) by the life

expectancy under Table V for B, age 66 (19.2 - .5 [frequency

multiple]; ($760.78 ÷ 18.7)                                                                              $ 40.68

Add the amount originally determined with respect to post-

June 1986 investment in the contract                                                             $640.39

Amount excludable with respect to post-June 1986

investment

                                                                                                                  $681.07

The variable annuity may be payable on a basis which is analogous to a joint and survivor level-payment annuity. In other words, proceeds from the same number of units may be payable during the joint lifetime of two persons and the lifetime of the survivor. In such case, the investment in the contract is divided by the joint and last survivor multiple from Table II or Table VI (Use annuitant’s age on birthday nearest the annuity starting date. If payments are to be received less frequently than monthly, an adjustment must be made to Table I or V and Table II or VI multiples, according to the Frequency of Payment Adjustment Table. No adjustment for frequency of payment need be made to a Table III or VII multiple.) to obtain the amount excludable from gross income each year.

On the other hand, the annuity may be payable on a non-level basis. For example, the proceeds of 8 units might be payable to a husband for as long as he lives, but proceeds from only 6 units would be payable to his wife if she survives him. The regulations provide a method for determining the yearly excludable amounts under such an annuity. See Treas. Reg. §1.72-5(b)(7). See also Rev. Rul. 58-236, 1958-1 CB 37.

“Investment annuity” and “wraparound annuity” are terms for arrangements under which an insurance company agrees to provide an annuity funded by investment assets placed by or for the policyholder with a custodian or by investment solely in specifically identified assets, such as XY Mutual Fund, held in a segregated account of the insurer.

Types of Annuities

IRS has ruled that under such arrangements sufficient control over the investment assets is retained by the policyholder so that income on the assets prior to the annuity starting date is currently taxable to the policyholder rather than to the insurance company.

Assets in an insurance company separate account invested solely in shares of a designated mutual fund generally available to the public are considered owned by the contract owners. *Christoffersen v. U.S.,* 749 F.2d 513 (8th Cir. 1984), rev’g 84-1 USTC 83,400 (N.D. Iowa 1984), *cert. denied;* Rev. Rul. 81-225, 1981-2 CB 12. Unless the mutual fund shares in the account are available to the public only through the purchase of an annuity contract, income on amounts contributed after December 31, 1980 may (depending on type of income) be taxable to the individual contract owners, except in the case of Individual Retirement Annuities, tax sheltered 403(b) annuities and annuities under a qualified 403(a) retirement plan. Contracts in those last three categories purchased on or before September 25, 1981 will continue to be treated as annuity contracts if no contributions are made for anyone not included under the contract on or before September 25, 1981. Rev. Rul. 81-225, supra. See IR 82-19 containing additional grandfather provisions.

For taxable years beginning after December 31, 1983 (excepting the underlying accounts of those contracts grandfathered under Rev. Rul. 81-225, above), the underlying investments of the segregated asset accounts of variable contracts must be “adequately diversified,” in accordance with regulations prescribed by the IRS. IRC Sec. 817(h); Reg. §1.817-5. However, the underlying accounts of a segregated asset account, the owner of which at all times after December 31, 1983 was considered to be the insurance company under the principles of Revenue Ruling 81-225, above, must be diversified according to the prescribed regulations only after December 15, 1986. Treas. Reg. §1.817-5(i)(2). See also Ann. 86-129, 1986-52 IRB 22.

Where amounts paid to the insurance company under an annuity contract were deposited by the insurer into a separate account for the policyholder with the savings and loan company to invest in the saving and loan’s certificates designated by the depositor and to reinvest in similar certificates or passbook accounts, IRS ruled the effect was that the policyholder directly maintained the investment himself. Consequently, it ruled that the policyholder was to be taxed as owner of the account. Rev. Rul. 80-27, 1980-2 CB 27.

The Service has ruled on whether the “hedge funds” within the sub-accounts of variable annuities and variable life insurance contracts will be treated as owned by the insurance company or the contract owner. Generally, if the hedge funds are available to the

Types of Annuities

general public, the sub-account will be treated as owned by the contract owner and therefore not entitled to tax deferral. However, if the hedge funds are available only through an investment in the variable annuity, tax deferral is available. Rev. Rul. 2003-92, 2003-33 IRB 350. The Service has also ruled that contract owners of variable annuities can invest in sub-accounts that invest in mutual funds that are available to the general public without losing the variable annuity's tax deferral. Let. Rul. 200420017.

# Refund Beneficiary: Life Income with Refund or Period-Certain Guarantee

Where a life annuity contract or life income settlement guarantees the payment of a stipulated minimum amount, or guarantees a certain minimum number of payments, and the annuitant dies during the guarantee period, his beneficiary will receive the balance of the guarantee.

Provided that the refund beneficiary cannot receive more than the amount guaranteed, the beneficiary may exclude all amounts received from gross income until such amounts, when added to amounts that were excludable from the annuitant’s gross income, exceed the investment in the contract; the excess, if any, is taxable income. This amount is considered paid in full discharge of the obligation under the contract in the nature of a refund of consideration and therefore comes under the cost recovery rule regardless of when the contract was entered into or when investments were made in the contract. IRC Sec. 72(e)(5)(E); Treas. Reg. §1.72-11(a), (c). (The example below is taken generally from Treas. Reg. §1.72-11(c).)

*Example 1.* (Period-certain.) Mr. White, age 60, purchases an immediate annuity with a 10 year period-certain guarantee which will pay him $150 a month ($1,800 a year) and names his daughter, Sara, as contingent payee. The cost of the contract is $7,200.

After receiving payments for 5 years (a total of $9,000), Mr. White dies and Sara begins receiving the $150 monthly payments in the sixth year.

Since the exclusion ratio for the annuity payments to Mr. White was 19.6%, (see Reg. §1.72-11(c) in which the value of the refund feature is subtracted from the investment in the contract) he has excluded from his gross income $352.80 a year, or a total of $1,764 (5 × $352.80) during the five-year period.

Types of Annuities

Sara may, therefore, receive tax-free an amount equal to the balance of the net premium cost; that is, $5,436 ($7,200 - $1,764). Thus, she will receive the $150 monthly payments tax-free ($5,436 ÷ 12 = 36.02 payments) for the next 3 years (36.02 payments ÷ $12) and $38 of the first payment of the ninth year. However, this result will differ slightly following a change made by the Small Business Job Protection Act of 1996 (P.L. 104-188). Effective for individuals with annuity starting dates after December 31, 1986, this legislation changed the manner in which the unrecovered investment in the contract is calculated for this purpose when the annuity has a refund or guarantee feature. Generally, the portion of any amount received as an annuity that can be excluded using the exclusion ratio is not to exceed the unrecovered investment in the contract. In calculating this figure, the value of the refund or guarantee feature was subtracted prior to the 1996 Act. After the 1996 Act, for this purpose, the value of the refund or guarantee feature is not subtracted. Although this change was made in 1996 legislation, it is effective for individuals with annuity starting dates after December 31, 1986. IRC Sec. 72(b)(4). Thus, Sara will recover slightly more of the payments she receives tax-free if this change is applicable.

*Example 2.* (Cash refund.) Mr. Black, at age 45, purchases a retirement annuity to mature at age 65. The annual gross premium is $1,000. Dividends, amounting to $3,000 over the 20-year period, are applied to reduce current premiums. Thus, the net premium cost of the contract is $17,000 ($20,000 - $3,000).

At age 65, the cash value of the contract is $24,700. Mr. Black elects a cash refund life annuity which will pay him $136 a month, or $1,632 a year, and names his daughter, Dora, refund beneficiary.

After receiving payment for 2 years (a total of $3,264), Mr. Black dies, and Dora receives the cash refund of $21,436 ($24,700 - $3,264).

Since the exclusion ratio for the annuity payments was 52.8%, Mr. Black has excluded from his gross income $861.70 a year, or a total of $1,723.40 (2 × $861.70) during the 2-year period. Dora may, therefore, receive tax-free an amount equal to the balance of net premium cost; that is, $15,276.60 ($17,000 - $1,723.40). She must report as taxable income $6,159.40 ($21,436 - $15,276.60). (Note that the change made by 1996 legislation discussed above in Example 1 may apply to this example also.)

Types of Annuities

If the refund is to be applied toward an annuity on her life (and, thus, the refund beneficiary might receive more than the amount guaranteed at the annuitant’s death), the payments will be taxable under the basic annuity rule. The application of the refund toward an annuity on her life is treated as a tax-free exchange of the old annuity for a new one, and a new exclusion ratio will be calculated as of the new starting date. Treas. Regs. §1.72-11(c), §1.72-11(e).

If any portion of the refund is considered “income in respect of a decedent,” the beneficiary may be entitled to an income tax deduction with respect to the portion of the refund included in the beneficiary’s gross income. Consequently, where the value of the refund has been included in annuitant’s gross estate, the beneficiary may be entitled to a small income tax deduction for any estate tax attributable to including the taxable portion of the refund in the gross estate. IRC Sec. 691(c); Treas. Reg. §1.691(c)-1; I.T. 3744, 1945 CB 192.

If the refund beneficiary of an annuitant whose annuity starting date is after July 1, 1986 does not recover the balance of the investment in the contract which was not recovered by the annuitant, he may take a deduction for the unrecovered balance. IRC Sec. 72(b)(3)(B).

Amounts received by a beneficiary after the death of the annuitant are not subject to the 10% penalty tax.