How are annuity payments taxed?

The basic rule for taxing annuity payments (i.e., "amounts received as an annuity") is designed to return the purchaser’s investment in equal tax-free amounts over the payment period (e.g., the annuitant’s life expectancy or a guaranteed certain period of time) and to tax the balance of each payment received as earnings. Each payment, therefore, is part nontaxable return of cost and part taxable income. Any excess interest (dividends) added to the guaranteed payments is reportable as income for the year received.

# Non-Variable Contracts

For non-variable contracts, an exclusion ratio (which may be expressed as a fraction or as a percentage) must be determined for the contract. This exclusion ratio is applied to each annuity payment to find the portion of the payment that is excludable from gross income. The balance of the guaranteed annuity payment is includable in gross income for the year received.[[1]](#footnote-1)

 The exclusion ratio of an individual whose annuity starting date is after December 31, 1986 applies to payments received until the payment in which the investment in the contract is fully recovered (generally, at life expectancy). In that payment, the amount excludable is limited to the balance of the unrecovered investment. Payments received thereafter are fully includable in income, as all cost basis has been recovered at that point.[[2]](#footnote-2) By contrast, the exclusion ratio as originally determined for an annuity starting date before January 1, 1987 applies to all payments received throughout the entire payment period, even if the annuitant has recovered his or her investment. Thus, it is possible for a long-lived annuitant with a pre-January 1, 1987, annuity to receive tax-free “return of principal” amounts which in the aggregate exceed the principal (investment in the contract).

The exclusion ratio for a particular contract is the ratio that the total investment in the contract (Q 456) bears to the total expected cumulative return payments (known in this case as the “expected return”) under the contract. By dividing the investment in the contract by the expected return, the exclusion ratio can be expressed as a percentage (which the regulations indicate should be rounded to the nearest tenth of a percent).[[3]](#footnote-3)

How are annuity payments taxed?

For example, assuming that the investment in the contract is $12,650 and expected return is $16,000 (e.g., $800/year for 20 years), the exclusion ratio is $12,650/$16,000, or 79.1 percent (79.06 rounded to the nearest tenth of a percent). If the monthly payment is $100, the portion to be excluded from gross income is $79.10 (79.1 percent of $100), and the balance of the payment is included in the gross income. If twelve such monthly payments are received during the taxable year, the total amount to be excluded for the year is $949.20 (12 × $79.10), and the amount to be included in income is $250.80 ($1,200 - $949.20). Excess interest, if any, also must be included.

If the investment in the contract equals or exceeds the expected return, the full amount of each payment is received tax-free.[[4]](#footnote-4)

# Variable Contracts

The exclusion ratio described above does not apply to payments made under a variable contract, as the expected return cannot be known in advance.

1. IRC Sec. 72(b)(1). [↑](#footnote-ref-1)
2. IRC Sec. 72(b)(2). [↑](#footnote-ref-2)
3. Treas. Reg. §1.72-4(a)(2). [↑](#footnote-ref-3)
4. Treas. Reg. §1.72-4(d)(2). [↑](#footnote-ref-4)