How do the net investment income rules apply to amounts received under an annuity contract?

Income from annuities included in gross income pursuant to IRC Sections 72(a) and 72(b) are also included in net investment income pursuant to IRC Section 1411(c)(1)(A)(i). For regular income tax purposes, a portion of an annuity payment is allocated to the taxpayer’s investment in the annuity. That amount is excluded from gross income,[[1]](#footnote-1) and, thus, not treated as net investment income. The difference between the total payment and the excluded amount is included in gross income,[[2]](#footnote-2) as well as net investment income.[[3]](#footnote-3)

*Example*: In 2015, Amy Annuitant received $12,000 in annuity payments of which $7,000 was allocated to her investment in the annuity. As a result, pursuant to IRC Section 72(b), Amy would exclude $7,000 of the payments from gross income and net investment income. The difference between the total annuity payment of $12,000 and her $7,000 basis, or $5,000 would be included in gross income and in net investment income, subject to the net investment income tax.

If the taxpayer *sells* the annuity contract for a gain, the entire gain would be treated as net investment income either under IRC Section 1411(c)(1)(A)(i) (as annuity income) or 1411(c)(1)(A)(iii) (net gain attributable to the sale of property). For example, if the sales price of the annuity does not exceed the annuity surrender value, the gain recognized (difference between the sales price and the taxpayer’s investment or basis in the annuity) is treated as annuity income. If the sales price exceeds the annuity surrender value, the portion of the gain attributable to the difference between the surrender value and the taxpayer’s investment or basis in the annuity is also treated as annuity income. However, the gain attributable to the difference between the sales price and the surrender value of the annuity would be treated as net gain attributable to the sale of the annuity.[[4]](#footnote-4)

1. IRC Section 72(b). [↑](#footnote-ref-1)
2. IRC Section 72(a). [↑](#footnote-ref-2)
3. Treas. Reg. §1.1411-4(a)(1)(i). See also Preamble to Proposed Regulations, 77 Fed. Reg. 72618; Preamble to Final Regulations, 78 Fed. Reg. 72394. [↑](#footnote-ref-3)
4. IRC Section 1411(c)(1)(A)(iii). [↑](#footnote-ref-4)