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An annuitant is entitled to recover his investment in the contract tax-free from the annuity payments.

A fixed portion of each payment is excludable from gross income as a return of capital, and the balance of the payment is treated as taxable income.

In order to arrive at the excludable portion of the payments under a particular contract, an “exclusion ratio” must be determined at the beginning of the liquidation period or, more precisely, at the “annuity starting date.”

# Annuity Starting Date after 1986

As a rule, the portion of any payment that is excludable under the exclusion ratio by an individual whose annuity starting date is after December 31, 1986, is limited to the unrecovered investment in the contract immediately before receipt of that payment. IRC Sec. 72(b)(2).

Unrecovered investment in the contract as of any date is the investment in the contract as of the annuity starting date less the aggregate amount received under the contract on or after the annuity starting date and before the date of the payment to the extent such amount was excludable from income. IRC Sec. 72(b)(4). Thus, the exclusion ratio applies to payments received until the payment in which the investment in the contract is fully recovered. In that payment, the amount excludable is limited to the balance of the unrecovered investment. Payments received thereafter are fully includable in income.

# Annuity Starting Date before 1987

Note, however, that the exclusion ratio as originally determined at the annuity starting date, if such date is before January 1, 1987, applies to all payments received throughout the entire payment period, regardless of whether the annuitant has recovered his investment. For example, life income payments received after the annuitant has outlived his life expectancy and recovered his investment are still taxed under the exclusion ratio as originally determined. Thus, it is possible for a long-lived annuitant to receive tax-free amounts which in the aggregate exceed his investment in the contract.

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# The Exclusion Ratio

The “exclusion ratio” is the ratio that the total investment in the contract bears to the total expected return under the contract. The exclusion ratio may be expressed either as a fraction or as a percentage. Usually it is expressed as a percentage. This percentage is obtained by dividing the total investment in the contract by the total expected return under the contract, and rounding off the quotient (as indicated in the regulations) to the nearest tenth of a percent. Treas. Reg. §1.72-4(a).

The percentage obtained in this manner is the percentage of each payment (consisting of principal and guaranteed interest) which may be excluded from gross income. The balance of the payment must be included in gross income. Any excess interest is also taxable.

For example, assuming that the total investment in the contract is $12,650, and the total expected return under the contract is $16,000, the exclusion ratio is $12,650/$16,000, or 79.1% (79.06% rounded to the nearest tenth). If the payments are monthly payments of $100, the portion of each payment to be excluded from gross income is $79.10 (79.1% of $100). If 12 such monthly payments are received during the taxable year, the total amount to be excluded for the year is $949.20 (79.1% of $1,200). The balance – $250.80 ($1,200 - $949.20) – is the amount to be included in gross income. But if only 5 such payments are received during the taxable year (as in the first year where payments begin in August), then $395.50 (79.1% of $500) is the amount to be excluded from gross income.

Of course, if the total investment in the contract equals or exceeds the total expected return, the exclusion ratio is 100%, and the full amount of each payment is received tax-free. Treas. Reg. §1.72-4(d)(2). This could happen, for example where cash surrender values, totaling less than net premium cost, are received under a settlement option. Excess interest, if any, however, is taxable.

There are a few situations which require the computation of a new exclusion ratio. If a contract is sold after the annuity payments commence, a new exclusion ratio must be determined for the purchaser. A new exclusion ratio must be determined in some instances where there is a partial lump sum withdrawal of principal after the payments commence. And, under some circumstances, an annuitant who is receiving a variable annuity may elect to compute a new exclusion ratio.

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# Definitions

The computation of exclusion ratios requires an understanding of 3 terms as they are used in the Code and regulations. These terms, along with the numbers of the sections where they are explained, are as follows:

1. Annuity starting date;

2. Investment in the contract;

3. Expected return.

Succeeding sections explain the adjustments that must be made in applying the basic annuity rule to the various types of annuity payments: e.g., straight life annuity; refund and period certain life annuities; joint and survivor annuities; fixed amount and fixed period installments; etc.

# Withholding

Amounts received under a private annuity contract are not subject to withholding because such amounts are not paid under a “commercial annuity,” that is, one issued by a licensed insurance company.

On the other hand, amounts received under commercial annuity contracts and as living proceeds of life insurance and endowment contracts are subject to withholding; however, the payee may elect not to have anything withheld. Only the amount it is reasonable to believe is includable in income is subject to withholding. (Note that eligible rollover distributions from tax sheltered annuities and qualified retirement plans may be subject to a mandatory withholding rate.)

Amounts are to be withheld from periodic payments at the same rate as wages. Payments are periodic, even if they are variable, if they are payable over a period of more than a year. If payments are not periodic, 10% of the includable amount is withheld. Payments made to the beneficiary of a deceased payee are subject to withholding under the same rules. IRC Sec. 3405; Temp. Treas. Reg. §35.3405-1T (A-9, A-10, A-12, A-17).

An election out of withholding will be ineffective, generally, for payments or distributions made after December 31, 1984 if a payee does not furnish his taxpayer identification number (TIN, usually his social security number) to the payor or furnishes an incorrect TIN to the payor and the payor is so notified by the IRS. IRC Sec. 3405(e)(12).

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# Annuity Starting Date

The exclusion ratio is determined as of the “annuity starting date.”

The Code provides that: “the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.” IRC Sec. 72(c)(4).

In the case of a single premium immediate annuity contract, the annuity starting date is usually the date of purchase. For example, if an individual purchases an immediate annuity on July 1, 1987 which provides for monthly payments beginning August 1, 1987, the annuity starting date is July 1, 1987 (the first monthly payment is for the period beginning July 1st).

Payments under settlement options, however, usually commence at the beginning, rather than at the end of the month or other payment period; hence the annuity starting date is the date of the first payment.

# Investment in the Contract

To find the exclusion ratio for payments under a particular contract, the total “investment in the contract” must be divided by the total “expected return” under the contract.

It is necessary, therefore, to know the exact amount of the policyholder’s “investment in the contract.” Generally speaking, this is the premium cost of the contract. It is not equal to the policy’s cash value. *Stoddard v. Comm.*, TC Memo 1993-400. However, “investment in the contract,” as used in the Code and regulations, is a technical term referring to an amount which frequently requires careful computation. IRC Sec. 72(c); Treas. Reg. §1.72-6. Following are the general rules for determining the “investment in the contract.”

The first step in arriving at the “investment in the contract” is to determine the aggregate amount of gross premiums paid for the contract.

The aggregate amount of gross premiums includes only premiums paid for the basic contract. If extra premiums have been paid for supplementary features, such as waiver of premium, disability income and accidental death (double indemnity) benefits, the aggregate amount of these extra premiums must be subtracted from the total gross premium cost. Rev. Rul. 55-349, 1955-1 CB 232; *Estate of Wong Wing Non,* 18 TC 205 (1952).

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The amount of any loan treated as a distribution increases investment in the contract. IRC Sec. 72(e). The amount excludable does not affect the investment in the contract; furthermore, repayment of the loan does not affect the investment in the contract whether or not the loan was treated as a distribution. (See Conference Committee Report, TAMRA ’88, Vol. 134 Cong. Rec. No. 151, Part II, October 21, 1988, page H11030.) Except to the extent includable in income, the amount of any unrepaid policy loans must be subtracted in arriving at gross premium cost, since such an amount represents a tax-free return of part of the policyholder’s cost. Treas. Reg. §1.72-6(a)(1)(i).

If premiums have been paid in advance and discounted, only the discounted amount is considered as premium cost. However, any interest on the prepaid premiums that has been taxed to the policyholder may be added to the premium cost as part of the “investment in the contract.” Rev. Rul. 65-199, 1965-2 CB 20.

If the payments are from a nonparticipating contract, the gross premium cost is the “investment in the contract.” But if the payments are from a participating contract, the next step in determining the “investment in the contract” is to take into account the aggregate amount of dividends that have been credited to the contract.

If dividends have been received in cash or applied to reduce premium payments, the aggregate amount of such dividends, received or credited before the date of the first payment, must be subtracted from the aggregate gross premiums to the extent the dividends were excludable from gross income. Also, any dividends that have been applied against principal or interest on policy loans must be subtracted, but only to the extent they were excludable from gross income. The *net* premium cost, then, is the “investment in the contract.”

*Example 1.* Mr. Brown, at age 45, purchases a deferred participating annuity contract, to mature at age 65. The annual gross premium is $1,000. Mr. Brown elects to have dividends applied to reduce his premium payments. During the 20-year accumulation period the aggregate amount of dividends credited to the contract and applied to reduce premium payments is $2,700. The gross premium cost of the contract is $20,000 (20 × $1,000). But Mr. Brown’s “investment in the contract” is his net premium cost, or $17,300 ($20,000 - $2,700).

If excludable dividends are left on deposit with the company to accumulate at interest, their effect upon the “investment in the contract” depends upon whether the dividend accumulation is withdrawn or is applied to increase the size of the payments.

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If the dividend accumulation is withdrawn, the aggregate amount of dividends not includable in income (but not the amount of interest earned on the dividends) is subtracted from the gross premium cost. (The interest and includable dividends are not subtracted because they do not represent a refund of part of the gross premium cost; they are earned income which was taxable to the policyholder.)

*Example 2.* Mr. Green, at age 45, purchases a deferred participating annuity to mature at age 65. The annual gross premium is $1,000. Mr. Green elects to leave the dividends on deposit with the company to accumulate at interest. During the 20-year accumulation period, dividends totaling $2,700 are credited to the contract. The dividend accumulation at the end of the 20-year period is $3,220 ($2,700 dividends, and $520 interest). Before the first annuity payment, Mr. Green withdraws the entire dividend accumulation. His “investment in the contract” is $17,300 ($20,000 - $2,700).

But if the dividend accumulation (including interest) is applied to increase the size of the payments, the dividends and accumulated interest constitute part of the cost of the larger payments. In other words, “investment in the contract” is net premium cost plus dividends and interest (or, gross premium cost plus interest).

*Example 3.* At age 40, Mr. White purchases a $10,000 endowment to mature at age 65. The annual gross premium is $410. Mr. White leaves the dividends on deposit with the company to accumulate at interest. Upon maturity of the contract, Mr. White elects to receive the proceeds under an annuity option, and to use the dividend accumulation and interest to increase the size of the annuity payments. Aggregate dividends credited to the contract before the date of the first annuity payment amount to $2,700. And the total dividend accumulation, including interest, amounts to $4,000 ($2,700 dividends, and $1,300 interest). Mr. White’s “investment in the contract” is $11,550 (25 × $410 = $10,250, plus the $1,300 interest on the dividend accumulation).

Similarly, where dividends have been applied to purchase paid-up additional insurance, and proceeds from both the basic policy and the paid-up additions are payable under a life income or other installment option, *gross premiums* constitute the “investment in the contract” to be used in determining the exclusion ratio for the income payments (including income from the paid-up additions). In theory, the dividends reduce the cost of the basic policy but constitute the cost of the paid-up additions. It is as if the policyholder had received the dividends in cash and used them to purchase single premium insurance.

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*Example 4.* Mr. Black, at age 45, purchases a life-paid-up-at-65 policy in the face amount of $10,000. The annual gross premium is $443. Mr. Black elects to use dividends to purchase paid-up additional insurance. At age 65, Mr. Black decides to surrender his policy and to receive the cash values of both the basic policy and the paid-up additions under an annuity option. During the 20-year accumulation period a total of $2,170 in dividends has been credited to the policy and applied to purchase paid-up additional insurance. Mr. Black’s “investment in the contract” is his gross premium cost of $8,860 (20 × $443).

If the owner of an endowment contract constructively receives the maturity proceeds before electing an annuity option, he will be taxed on the gain from the contract in the year of maturity. Under such circumstances, the entire maturity value, rather than the policyholder’s premium cost, would constitute his “investment in the contract.” However, the Code provides that such proceeds are not constructively received if the policyholder elects a life income or other installment option within 60 days after the maturity of the contract. IRC Sec. 72(h); Treas. Reg. §1.72-12. If the maturity proceeds are neither actually nor constructively received in the year of maturity, the “investment in the contract” is premium cost, as computed according to the foregoing rules in this section.

Apparently the 60-day rule applies also with respect to cash surrenders. Consequently, if the policyholder elects to take the cash surrender value under a life income or other installment option, and the election is made before actual surrender, or within 60 days after surrender (but before he actually receives any cash), the “investment in the contract” is premium cost (whether more or less than the cash surrender value). But if the policyholder actually or constructively receives the cash surrender value before applying it to annuity payments, he will be taxed on gain, if any, in the year of surrender, and the cash surrender value will constitute his “investment in the contract.”

The maturity values of a retirement income contract or deferred annuity contract are not constructively received upon maturity. Where such maturity values are payable as an annuity, therefore, the “investment in the contract” is premium cost, computed according to the foregoing rules in this section.

If annuity payments are made under a contract that has been purchased from a previous owner, the “investment in the contract” is not the original owner’s premium cost; it is the consideration paid by the purchaser plus net premiums, if any, paid after the purchase.

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If the contract has been transferred as a gift, the premiums paid and dividends received by both donor and donee are taken into account in determining the “investment in the contract. For contracts issued after 1996, but only for tax years after 2009, a charge against the cash surrender value of an annuity contract or life insurance contract for a premium payment of a qualified long-term care contract that is a rider to the annuity or life insurance contract will reduce the investment in the contract of the annuity or life insurance contract. However, this charge against the cash surrender value will not cause the taxpayer to recognize gross income. IRC Sec. 72(e)(11), as amended by PPA 2006.

Where the annuity is for life or lives with refund or period certain guarantee, a special adjustment must be made to the investment in the contract. First, “investment in the contract” is determined according to the foregoing rules. Then the value of the refund or period certain guarantee must be subtracted from the amount so determined. It is this adjusted investment in the contract that is used in computing the exclusion ratio for the contract.

# Expected Return

The exclusion ratio for a particular contract is determined by dividing the total “investment in the contract” by the total “expected return” under the contract. The preceding section sets forth the general rules for determining the amount of the “investment in the contract.”

“Expected return” is the total amount that the annuitant or annuitants can expect to receive under the contract.

If payments are for a “fixed period,” not involving life contingency, expected return is computed by multiplying the amount of the *guaranteed* payment by the number of payments to be made. Treas. Reg. §1.72-5(c).

*Example 1.* The owner of a maturing $25,000 endowment elects to receive the proceeds in equal annual payments of $2,785 for a fixed 10-year period. The expected return under the contract is $27,850 (10 × $2,785).

Similarly, to arrive at expected return for payments under a “fixed amount” option, the amount of the guaranteed payment is multiplied by the number of payments required to exhaust the principal sum and guaranteed interest. Treas. Reg. §1.72-5(d).

*Example 2.* The owner of a maturing $25,000 endowment elects to take the proceeds in monthly payments of $200. The company’s rates show that payments of

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$200 are guaranteed for 144 months. The expected return under the contract is $28,800 (144 × $200).But if payments are to be made for a life or lives, the annual guaranteed return under the contract is multiplied by the life expectancy of the measuring life (or lives) to determine the “expected return” under the contract.

The life expectancy factor or factors must be taken from the Annuity Tables prescribed by Internal Revenue Service. In determining “expected return” for payments under annuity contracts, or for payments of lifetime maturity or cash surrender values, every taxpayer is required to use the annuity tables prescribed by IRS.

Generally, gender based Tables I - IV are to be used if the investment in the contract does not include a post-June 30, 1986 investment in the contract. Unisex Tables V - VIII are to be used if the investment in the contract includes a post-June 30, 1986 investment in the contract. However, transitional rules permit an irrevocable election to use the unisex tables even where there is no post-June 1986 investment and, if investment in the contract includes both a pre-July 1986 investment and a post-June 1986 investment, an election may be made in some situations to make separate computations with respect to each portion of the aggregate investment in the contract using with respect to each portion the tables applicable to it. Treas. Reg. §1-72-9.

The life expectancy factors in the IRS annuity tables are called “expected return multiples.”

If payments are for a single life, the expected return multiple is taken from Table I or Table V of the annuity tables, whichever is applicable.

If payments are to be made for joint lives, or on a joint and survivorship basis, an expected return multiple from Table II and/or Table IIA or Table VI and/or Table VIA, whichever is applicable, is used.

The Annuity Tables are entered with the age of the measuring life as of his or her birthday nearest the *annuity starting date*. The gender based tables provide different multiples for males and females, taking into account the longer life expectancy of the female. The unisex tables provide the same multiples for males and females.

If payments are to be made on a monthly basis, the multiples in Tables I, II and IIA or, as applicable, Tables V, VI, and VIA need not be adjusted.

But if payments are to be made less frequently than monthly – for example, quarterly, semi-annually, or annually – the appropriate multiples must be adjusted. A further

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adjustment is required where the interval between the annuity starting date and the date of the first payment is less than the interval between future payments.

*Example.* The multiple in Table V for a male, age 66, is 19.2. This multiple, adjusted for quarterly payments the first of which is to be made one full month after the annuity starting date, is 19.3 (19.2 + .1). For semi-annual payments, the first of which is to be made 6 full months from the annuity starting date, the adjusted multiple is 19.0 (19.2 - .2). For annual payments, the first of which is one full month from the annuity starting date, the adjusted multiple is 19.7 (19.2 + .5). If the annuitant is to receive an annual payment commencing 12 full months after his annuity starting date, the adjusted multiple is 18.7 (19.2 -.5).

Table IV or Table VIII (whichever is applicable) of the annuity tables is used in determining expected return for a temporary life annuity. A temporary life annuity provides for fixed payments to be made to an annuitant until his death or until the expiration of a specified limited period, whichever occurs earlier. Table IV or VIII also is entered with the annuitant’s age on birthday nearest the annuity starting date and sex (if applicable). However, the multiples in Table IV or VIII need not be adjusted for quarterly, semi-annual or annual payments.

The IRS annuity tables are composed of 8 tables. Table III and Table VII, however, are not used in determining expected return; they are used in making an adjustment to the “investment in the contract” where there is a refund or period certain guarantee in connection with a life annuity.