

Retirement Tax Planning With Personally Purchased Annuities

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Personally purchased annuity contracts can serve as tax-efficient complements to — or in some cases, as substitutes for — employer retirement plans and IRAs.¹ This article discusses the taxation of distributions received under personally purchased annuity contracts and the tax-planning decisions retirees and their beneficiaries must make. However, except for purposes of comparison, the article does not address the treatment of annuities provided by employers,² annuities under IRAs,³ life insurance contracts,⁴ endowment contracts,⁵ long-term

care insurance contracts,⁶ or contracts that do not satisfy the minimum distribution requirements described below.⁷ Different tax rules generally apply to those kinds of contracts.

I. Amounts Received as an Annuity

Payments to a retiree or his beneficiaries under a personally purchased annuity contract are taxable as annuity payments if the payments have the following characteristics:

1. the issuer of the contract makes the payments at regular intervals (for example, weekly, monthly, or annually);
2. the payments continue for more than one year after the annuity starting date; and
3. The total amount of all the expected payments is determinable on the annuity starting date.⁸

For that purpose, the annuity starting date is the first day of the first period an annuity amount is payable. For example, if the first payment is for the month of July, but the payment is not due until July 31, the annuity starting date is the first day of July.⁹

The total amount of expected future payments under item 3 above is often determinable directly from the terms of the annuity contract. In other cases, the total amount of the payments is determinable from actuarially sound mortality tables or compound interest computations, or both. In any event, however, the determination must also be consistent with the terms of the annuity contract.¹⁰

¹The regulations state that the term “annuity contract” generally includes those contracts considered annuity contracts under the customary practice of insurance companies. Reg. section 1.72-2(a)(1).

²See section 403; reg. sections 1.403(a)-1, 1.403(b)-1, 1.402(a)-1(a)(2), 1.402(b)-1(c)(1).

³See section 408(b); reg. section 1.408-3.

⁴The tax law generally treats a contract as a life insurance contract if the insurance industry would classify it as such (reg. section 1.72-2(a)(1)) and if it satisfies the somewhat complex requirements of section 7702. If a contract provides life insurance benefits, the tax law generally will not treat it as an annuity contract even though the contract may contain some annuity provisions. In the context of qualified retirement plans, the IRS has ruled that a life insurance contract with annuity elements generally does not cease being a life insurance contract and become an annuity contract merely because its cash value has grown to an amount exceeding its death proceeds (thus eliminating the life insurance risk). However, the IRS concedes that a contract is no longer a life insurance contract if the owner of the contract elects to begin payments under a settlement option or formally converts the contract to an annuity contract. Rev. Rul. 66-322, 1966-2 C.B. 123; LTR 198125016 (Mar. 24, 1981). The Tax Court, however, has more expansively held that a contract automatically ceases being a life insurance contract when its cash value exceeds the death proceeds. *Evans v. Commissioner*, 56 T.C. 1142 (1971).

⁵Endowment contracts generally provide for lump sum payments if the insured lives for a specified number of years, or to a specified age, and may provide death benefits if the insured should die earlier. The tax law generally treats a contract as an endowment contract if the insurance industry would classify it as such. Reg. section 1.72-2(a)(1). In addition, however, the tax

(Footnote continued in next column.)

law provides that, for purposes of section 72, “face amount certificates” are endowment contracts and not annuity contracts. Section 72(l). Face amount certificates are obligations of issuers to pay an amount or amounts more than 24 months after issuance in return for the prior receipt of periodic payments from the owner of the certificate. Face amount certificates also include an obligation of a “face amount certificate company” to make similar payments in return for an immediate lump sum payment from the owner of the certificate. 15 U.S.C. section 80a-2. Cf. section 401(g) (treating face amount certificates as annuity contracts for purposes of taxation of employer retirement plan benefits).

⁶Nor does the article address annuity contracts that also provide long-term care insurance. However, note that for years beginning after December 31, 2009, the code will treat such embedded long-term care insurance as if it were a contract separate from the basic annuity contract (if the annuity contract was issued after December 31, 1996). Pension Protection Act of 2006, P.L. 109-280, section 844(c), (g)(1); section 7702B(e).

⁷See *infra* text accompanying notes 23 through 32.

⁸Reg. section 1.72-2(b)(2).

⁹Section 72(c)(4); reg. section 1.72-4(b)(1).

¹⁰Reg. section 1.72-2(b)(2)(iii).

Thus, the total of the expected payments for a fixed number of years is normally determinable directly from the annuity contract (for example, two semiannual payments of \$5,000 per year for 10 years total \$100,000). By contrast, a retiree would determine total expected payments for his lifetime by reference to actuarially sound mortality tables.

The definition of amounts taxable as annuity payments is slightly different for variable annuities. The amounts of periodic payments under a variable annuity vary in accordance with investment experience, cost of living indices, foreign currency values, or similar criteria. However, variable annuity payments may qualify as amounts received as an annuity even though the total of the expected payments is not determinable. It is only necessary that the issuer make the periodic payments for a definite or determinable period (including a period based on lifetimes).¹¹

Payments under segregated asset annuities depend on and vary with the investment performance of underlying segregated assets owned by the issuer. Although the contracts often allow a retiree limited control over the allocation of premiums between underlying investment funds, the tax law imposes strict diversification and other requirements on the underlying investments. Nevertheless, as long as the requirements are satisfied, a segregated asset annuity is taxable to a retiree in the same way as any other variable annuity.¹²

II. Date Payments Begin

A retiree may generally begin receiving payments under a personally purchased annuity contract whenever allowed under the terms of the contract. However, the tax law will impose penalties on the payments if a retiree begins receiving them too soon. However, a retiree's beneficiaries (other than the retiree's spouse) *must* begin receiving distributions by a specifically designated date.

A. Starting Annuity Payments Without Penalty

If a retiree receives a payment under a personally purchased annuity contract, a 10 percent penalty will apply to the portion of the payment includable in taxable income unless one or more of several conditions is satisfied. Specifically, the penalty applies to a payment unless it is one of the types described below:¹³

1. Payments after the retiree reaches age 59½.¹⁴
2. Payments after the retiree's disability.¹⁵ The retiree is disabled if he cannot do substantial work

because of a physical or mental medical condition that will last for a long and indefinite period or from which the retiree is expected to die.¹⁶

3. Payments to a beneficiary after the retiree's death.¹⁷

4. Substantially equal periodic payments made annually (or more frequently) over (a) the retiree's lifetime, (b) the joint lifetimes of the retiree and his beneficiary, (c) a period equal to the retiree's life expectancy, or (d) a period equal to the joint life expectancies of the retiree and his beneficiary.¹⁸ The retiree may choose any one of three alternative methods to ensure that the payments are substantially equal. However, the penalty tax will apply retroactively to the payments (with interest) if the arrangement is modified before the later of the date the retiree reaches age 59½ or the date that is five years after the first payment. Modifications on death or disability do not trigger the retroactive penalty.¹⁹

5. Payments under an annuity contract (a) purchased with a single premium, (b) providing for substantially equal annuity payments (annually or more frequently) over the annuity period, with (c) an annuity starting date no later than one year after purchase (an immediate annuity).²⁰

6. Payments under certain annuity contracts funding personal injury judgments or settlements.²¹

7. Payments allocable to the investment in a contract before August 14, 1982, including any income accumulated on the investment. The tax law allocates payments to the pre-August 14, 1982, investment before allocating them to the post-August 13, 1982, investment.²²

Thus, a retiree who begins receiving annuity payments before age 59½ generally may avoid the penalty on the payments only by complying with the requirements of items 4 or 5 above (unless the retiree is disabled or receiving some payments for personal injury).

B. Latest Date Minimum Distributions May Begin

During their lifetimes, a retiree and his spouse may avoid taxable distributions from a personally purchased annuity contract as long as they do not exercise a payment option and the contract does not otherwise require payments.²³ However, the tax law does require minimum distributions for nonspousal beneficiaries.

¹¹Reg. section 1.72-2(b)(3)(i).

¹²Section 817; Rev. Rul. 2003-91, 2003-2 C.B. 347, *Doc 2003-17246*, 2003 TNT 142-18. If the requirements of section 817 are not satisfied, the retiree must include in gross income the gains, losses, and other income earned by the segregated assets underlying the annuity — as if the retiree directly owned those assets. Rev. Rul. 2003-92, 2003-2 C.B. 350, *Doc 2003-17252*, 2003 TNT 142-19.

¹³Section 72(q)(1).

¹⁴Section 72(q)(2)(A).

¹⁵Section 72(q)(2)(C).

¹⁶Section 72(m)(7).

¹⁷Section 72(q)(2)(B).

¹⁸Section 72(q)(2)(D).

¹⁹Section 72(q)(3); Rev. Rul. 2002-62, 2002-2 C.B. 710, *Doc 2002-22476*, 2002 TNT 193-7; Notice 2004-15, 2004-1 C.B. 526, *Doc 2004-4147*, 2004 TNT 40-11; Notice 89-25, 1989-1 C.B. 662.

²⁰Section 72(q)(2)(l), (u)(4).

²¹Section 72(q)(2)(G).

²²Section 72(q)(2)(F); Rev. Rul. 85-159, 1985-2 C.B. 29.

²³Section 72(s)(3).

Three types of distributions will satisfy that minimum requirement:

1. If the retiree dies on or after the annuity starting date, the issuer of the annuity contract may satisfy the distribution requirement by distributing the retiree's remaining interest "at least as rapidly as under the method of distributions being used as of the date of his death."²⁴ The IRS will likely interpret that language consistently with its interpretation of similar statutory language applicable to distributions from IRAs and qualified retirement plans.²⁵ If so, the issuer may continue distributing the remaining interest of the retiree over a hypothetical life expectancy based on the age the retiree reached or would have reached in the calendar year of his death.²⁶

2. If the retiree dies before the annuity starting date, the issuer of the contract may satisfy the requirement by distributing the retiree's entire remaining interest at any time over the five years following the retiree's death.²⁷

3. Alternatively, and regardless of when the retiree dies, the issuer may distribute the retiree's remaining interest over the life (or the life expectancy) of a designated beneficiary — starting within one year after the retiree's death.²⁸ Based on the IRS's interpretation of similar statutory language applicable to IRAs and qualified retirement plans,²⁹ it is likely the relevant designated beneficiary will be the oldest of the retiree's beneficiaries (all of whom must generally be individuals).³⁰

Most of the common types of personally purchased annuities will not run afoul of the minimum distribution requirements. For example, an annuity payable over the life of a retiree will generally not contravene the requirements, at least when the contract does not provide for any payments after the retiree's death. Similarly, annuities payable over the lives of the retiree and spouse will generally not contravene the requirements when the annuity contract does not provide for payments after the death of the last survivor.³¹ Finally, most annuities payable over the lives of the retiree and a nonspousal beneficiary will satisfy the minimum distribution alternative described in item 3, above.

Attempts to avoid the minimum distribution requirements by decreasing initial annuity payments and increasing future payments will probably not be successful. The IRS generally prohibits that type of backloading in

analogous situations involving IRAs or qualified retirement plans — except when non-tax-related events justify it.³²

III. Taxation of Annuity Payments

Generally, a portion of each annuity payment under a contract personally purchased by a retiree is nontaxable. To compute the nontaxable portion, a retiree or beneficiary need only multiply the payment by an exclusion percentage. The exclusion percentage is determined by dividing the investment in the annuity contract as of the annuity starting date by the total amount of the expected annuity payments (the expected return).³³

A. Determination of the Expected Return

The expected return under an annuity contract is a function of actuarial tables, the terms of the contract, or both. For annuities based on the lives of retirees (or the lives of retirees and their beneficiaries), a retiree must generally use the actuarial tables provided by the regulations. Those tables fall into two categories: gender-neutral tables³⁴ and gender-specific tables.³⁵

A retiree must use a gender-neutral actuarial table if the retiree made all of his investment in a contract after June 30, 1986.³⁶ However, if a retiree made all of his investment on or before June 30, 1986, the retiree must generally use a gender-specific table (unless he specifically elects to use a gender-neutral table).³⁷ If a retiree made some of his investment on or before June 30, 1986, and some after that date, the retiree may generally elect to use a gender-specific table (in conjunction with a gender-neutral table).³⁸ The retiree may make either of those elections on a statement attached to his tax return.³⁹

Nevertheless, the retiree may not in any event use a gender-specific table if the retiree's annuity starting date was after June 30, 1986, and the retiree had an option to receive a form of payment other than a life annuity. In that case, the retiree must use only the gender-neutral table (even if the option was exercisable by some other person).⁴⁰ For example, the retiree must use only a gender-neutral table if he has the option to receive a lump sum payment of the entire benefit; a nonannuity payment after June 30, 1986, and before the annuity starting date; or a fixed term annuity (including any substantial equivalent).⁴¹ For that purpose, an ordinary life annuity is substantially equivalent to a fixed term annuity if it provides for guaranteed payments with a value that is more than 50 percent of the value of the annuity.⁴²

²⁴Section 72(s)(1)(A).

²⁵See section 401(a)(9)(B)(ii). See also *Vorris Blankenship, "Maximizing Tax Deferral for Funds in Tax-Favored Retirement Plans and IRAs,"* 3 *CCH Financial and Estate Planning Reporter* para. 32,871 (2006), or *Journal of Retirement Planning*, Jan.-Feb. 2006, at 15.

²⁶Reg. section 1.401(a)(9)-5, Q&A 5(c)(3).

²⁷Section 72(s)(1)(B).

²⁸Section 72(s)(2).

²⁹See *Blankenship, supra* note 25.

³⁰See section 401(a)(9)(B)(iii); reg. sections 1.401(a)(9)-5, Q&A 7(a)(1), 1.401(a)(9)-4, Q&A 3.

³¹Section 72(s)(3).

³²See reg. section 1.401(a)(9)-6; *Blankenship, supra* note 25.

³³Section 72(b)(1).

³⁴Reg. section 1.72-9, tables V, VI, VIA, VII, and VIII.

³⁵Reg. section 1.72-9, tables I, II, IIA, III, and IV.

³⁶Reg. section 1.72-9.

³⁷See *id.*

³⁸Reg. sections 1.72-6(d)(3), (d)(6), 1.72-9.

³⁹Reg. sections 1.72-6(d)(6), 1.72-9.

⁴⁰Reg. sections 1.72-6(d)(3)(i)(C), 1.72-9.

⁴¹Reg. section 1.72-6(d)(3)(iii).

⁴²Reg. sections 1.72-6(d)(3)(iv), 1.72-9, Table VII.

B. Expected Returns for Common Annuities

The immediately following discussion explains the expected return for each of the more common types of annuities — that is, for annuities providing:

1. a specific number of periodic payments over a fixed period (a fixed term annuity);
2. payments over the retiree's lifetime (an ordinary life annuity);
3. payments over the retiree's lifetime and, after the retiree's death, payments of the same amount over the lifetime of a beneficiary (an ordinary joint and survivor annuity);
4. payments over the retiree's lifetime and, after the retiree's death, payments of a different amount over the lifetime of a beneficiary (a stepped joint and survivor annuity); and
5. variable annuity payments over the retiree's lifetime (a variable life annuity).

1. Fixed term annuities. If an annuity purchased by a retiree is a fixed term annuity (that is, it requires a specific number of periodic payments over a specified period), the computation of the nontaxable amount of each annuity payment is relatively simple. The retiree or beneficiary first computes the expected return by multiplying the periodic payment amount by the number of payments required during the term of the annuity.⁴³ The retiree or beneficiary then computes the exclusion percentage by dividing the investment in the annuity by the expected return.

Example. If a retiree is entitled to annuity payments of \$3,000 per month over a fixed term of 10 years, the expected return under the annuity is \$360,000. That expected return is computed by multiplying the \$3,000 monthly payment by the 120 payments the retiree is entitled to receive (that is, 12 monthly payments per year multiplied by the 10-year term).

Assuming the investment in the annuity is \$100,000, the exclusion percentage is 27.7778 percent (determined by dividing the \$100,000 investment by the \$360,000 expected return). Thus, the retiree does not pay tax on \$833.33 of each \$3,000 payment (the \$3,000 payment multiplied by the exclusion percentage of 27.7778 percent).

2. Ordinary life annuities. If a retiree purchases an ordinary life annuity (that is, an annuity payable over the retiree's lifetime), the nontaxable portion of each annuity payment depends on the retiree's life expectancy. The retiree determines the expected return on the annuity by multiplying the total amount of the annuity payments received each year by the retiree's life expectancy found in the actuarial tables in the regulations. However, as previously noted, the particular table the retiree uses may differ depending on whether the retiree made some or all of the investment in the annuity on or before June 30, 1986.⁴⁴

Example 1 — Entire Investment Made After June 30, 1986. Assume a retiree personally purchases an ordinary life annuity paying \$3,000 per month for his lifetime. Assume his investment in the annuity contract is \$100,000 (all invested after June 30, 1986), and he reaches age 62 on his birthday nearest the annuity starting date.

The retiree's expected return under the annuity is \$810,000. He computes this expected return by multiplying the total \$36,000 amount paid each year (12 months at \$3,000 per month) by the additional 22.5 years that a 62-year-old person normally lives based on regulation Table V, Ordinary Life Annuities; One Life.⁴⁵

Thus, the retiree's exclusion percentage is 12.3457 percent (determined by dividing his \$100,000 investment by the \$810,000 expected return). Consequently, \$370.37 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 12.3457 percent).

Example 2 — Entire Investment Made on or Before June 30, 1986. Assume that in Example 1 the retiree made all his investment in the annuity contract on or before June 30, 1986, and the contract does not provide any payment options other than the ordinary life annuity. If so, the retiree may use Table I (the gender-specific table) rather than Table V (the gender-neutral table).

Table I shows a life expectancy of 16.9 years for a man age 62.⁴⁶ It follows that the retiree's expected return under the annuity is \$608,400. He determines the expected return by multiplying the \$36,000 paid each year (12 months at \$3,000 per month) by his 16.9-year life expectancy.

Consequently, the retiree's exclusion percentage is 16.4366 percent (determined by dividing his \$100,000 investment in the annuity by the \$608,400 expected return). Thus, \$493.10 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 16.4366 percent).

Nevertheless, the retiree may *elect* to use Table V (as in Example 1) even though he made all his investment in the annuity on or before June 30, 1986. The retiree makes the election by attaching a statement to his tax return.⁴⁷

Example 3 — Part of Investment Made on or Before June 30, 1986. Assume that in Example 2, the retiree made only \$30,000 of his \$100,000 investment in the annuity on or before June 30, 1986, but that he elected to make use of the gender-specific table. In that case, the exclusion percentage for the \$30,000 portion of the investment is 4.9310 percent (the \$30,000 investment divided by the \$608,400 expected return computed in Example 2). The exclusion percentage for the remaining \$70,000 investment (made after June 30, 1986) is 8.6420 percent (the \$70,000 investment divided by the \$810,000 expected return computed in Example 1).

⁴³Section 72(c)(3)(B); reg. section 1.72-5(c).

⁴⁴Reg. sections 1.72-5(a)(1), 1.72-9, tables I and V.

⁴⁵Reg. section 1.72-9, Table V.

⁴⁶Reg. section 1.72-9, Table I.

⁴⁷Reg. section 1.72-9.

The combined exclusion percentage is 13.5730 percent (the sum of the two computed exclusion percentages of 4.9310 percent and 8.6420 percent). Thus, \$407.19 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the combined exclusion percentage of 13.5730 percent).

As explained above, a retiree may have a choice between gender-based Table I and gender-neutral Table V to determine the nontaxable portion of annuity payments. Generally, the choice of Table I should maximize the nontaxable portion of annuity payments for a male — or for a female under age 79. However, a female age 79 or older could generally maximize the nontaxable amount by choosing Table V.

3. Ordinary joint and survivor annuities. If a retiree personally purchases an ordinary joint and survivor annuity (that is, an annuity of equal payments over the lifetimes of the retiree and a beneficiary), the nontaxable amount of each annuity payment depends on the life expectancies of the retiree and his beneficiary. The retiree determines the expected return on the annuity by multiplying the total amount of the annuity payments received each year by the combined life expectancies of the retiree and beneficiary derived from actuarial tables in the regulations.⁴⁸ Again, the particular table the retiree uses may differ depending on whether the retiree made some or all of his investment in the annuity on or before June 30, 1986.⁴⁹

Example 1 — Entire Investment Made After June 30, 1986. Assume a retiree personally purchases an ordinary joint and survivor annuity providing payments of \$3,000 per month. Assume the retiree's investment in the annuity contract is \$100,000 (all invested after June 30, 1986), and he reaches age 62 on his birthday nearest the annuity starting date. Assume also that at the retiree's death the annuity will continue to be paid to his surviving spouse, who reaches age 60 on her birthday nearest the annuity starting date.

The expected return under the annuity is \$1,036,800. The retiree computes this expected return by multiplying the \$36,000 amount paid each year (12 months at \$3,000 per month) by 28.8 years. The 28.8 years is the joint and survivor life expectancy of the retiree and his spouse found in regulation Table VI, Ordinary Joint Life and Last Survivor Annuities; Two Lives.⁵⁰

Thus, the retiree's exclusion percentage is 9.6451 percent (determined by dividing the \$100,000 investment in the annuity by the \$1,036,800 expected return). Consequently, \$289.35 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 9.6451 percent).

Example 2 — Entire Investment Made on or Before June 30, 1986. Assume that in Example 1 the retiree made all of his investment in the annuity contract on or before June 30, 1986, and the contract does not

provide any payment options other than the ordinary joint and survivor annuity. In that case, the retiree would ordinarily compute his expected return using Table II (a gender-specific table in the regulations) rather than Table VI (a gender-neutral table).

Table II shows a joint and survivor life expectancy of 25.4 years for a 62-year-old male and a 60-year-old female.⁵¹ It follows that the retiree's expected return under the annuity is \$914,400. The retiree determines the expected return by multiplying the \$36,000 paid each year (12 months at \$3,000 per month) by the 25.4-year joint and survivor life expectancy.

Consequently, the retiree's exclusion percentage is 10.9361 percent (determined by dividing his \$100,000 investment in the annuity by the \$914,400 expected return). Thus, \$328.08 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 10.9361 percent).

Nevertheless, the retiree may *elect* to use Table VI (as in Example 1) even though he made all the investment in the annuity on or before June 30, 1986. The retiree may make the election by attaching a statement to his tax return.⁵²

Example 3 — Part of Investment Made on or Before June 30, 1986. Assume that in Example 2, the retiree made only \$30,000 of his \$100,000 investment in the annuity on or before June 30, 1986, but that he elected to make use of the gender-specific table. In that case, the exclusion percentage for the \$30,000 portion of the investment is 3.2808 percent (the \$30,000 investment divided by the \$914,400 expected return determined in Example 2). The exclusion percentage for the remaining \$70,000 investment (made after June 30, 1986) is 6.7515 percent (the \$70,000 investment divided by the \$1,036,800 expected return determined in Example 1).

The combined exclusion percentage is 10.0323 percent (the sum of the two computed exclusion percentages of 3.2808 percent and 6.7515 percent). Thus, \$300.97 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the combined exclusion percentage of 10.0323 percent).

As explained above, a retiree may have a choice between the gender-based Table II and the gender-neutral Table VI, to determine the nontaxable portion of his annuity payments. Generally, the choice of Table II should maximize the nontaxable portion of the annuity payments. However, in some unusual situations, Table VI may be more favorable. Thus, a retiree should always compare the tables to determine which table works best.

4. Stepped joint and survivor annuities. A retiree may have personally purchased a stepped joint and survivor annuity (that is, an annuity payable over the retiree's lifetime and, after the retiree's death, payable in a different amount over his beneficiary's lifetime). If so, the nontaxable amount of each annuity payment depends on

⁴⁸Reg. section 1.72-5(b)(1).

⁴⁹Reg. section 1.72-9, tables II and VI.

⁵⁰Reg. section 1.72-9, Table VI.

⁵¹Reg. section 1.72-9, Table II.

⁵²Reg. section 1.72-9.

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the life expectancies of the retiree and his beneficiary, and the differing amounts of their annuity payments.

The expected return on the annuity is the sum of two partial expected returns, based in turn on the IRS's actuarial tables. The first partial expected return is equal to the total amount of the retiree's annuity payments each year multiplied by the retiree's life expectancy. The second partial expected return is equal to the total amount of annuity payments to the beneficiary each year multiplied by the number of years the beneficiary may expect to receive the payments based on the joint and survivor life expectancies of the retiree and beneficiary.⁵³ The particular actuarial tables the retiree must use may differ depending on whether the retiree made some or all of the investment in the annuity on or before June 30, 1986.⁵⁴

Example 1 — Entire Investment Made After June 30, 1986. Assume a retiree personally purchases a stepped joint and survivor annuity providing him with lifetime annuity payments of \$3,000 per month. Assume his investment in the annuity is \$100,000 (all invested after June 30, 1986), and he reaches age 62 on his birthday nearest the annuity starting date. Assume also that his spouse reaches age 60 on her birthday nearest the annuity starting date and, after the retiree's death, his spouse will receive lifetime annuity payments of \$1,500 per month.

The part of the expected return attributable to the retiree's lifetime payments is \$810,000. He computes this partial expected return by multiplying the \$36,000 amount paid to him each year (12 months at \$3,000 per month) by the 22.5-year life expectancy of a 62-year-old person found in regulation Table V, Ordinary Life Annuities; One Life.⁵⁵

The part of the expected return attributable to his spouse's lifetime payments is \$113,400. He computes this partial expected return by multiplying the \$18,000 amount paid to his spouse each year (12 months at \$1,500 per month) by the 6.3 years his spouse could expect to receive the payments. He computes the 6.3 years by subtracting his 22.5-year life expectancy under Table V from his and his spouse's 28.8-year joint and survivor life expectancy under regulation Table VI, Ordinary Joint Life and Last Survivor Annuities; Two Lives.⁵⁶

The total expected return is \$923,400 (the sum of the partial expected returns of \$810,000 and \$113,400 attributable to the retiree and his spouse, respectively). Thus, the exclusion percentage is 10.8295 percent (determined by dividing the \$100,000 investment in the annuity by the \$923,400 total expected return).

Consequently, \$324.89 of each of the retiree's \$3,000 payments is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 10.8295 percent). If the retiree's spouse survives him, \$162.45 of each of the

spouse's \$1,500 payments is nontaxable (the \$1,500 payment multiplied by the exclusion percentage of 10.8295 percent).

Example 2 — Entire Investment Made on or Before June 30, 1986. Assume that in Example 1 the retiree made all of his investment in the annuity contract on or before June 30, 1986, and the contract does not provide any payment options other than the stepped joint and survivor annuity. In that case, he would ordinarily compute his expected return by using tables I and II (gender-specific tables in the regulations) rather than tables V and VI (gender-neutral tables).

The part of the expected return attributable to the retiree's lifetime payments is \$608,400. That partial expected return is determined by multiplying the \$36,000 amount paid to the retiree each year (12 months at \$3,000 per month) by the 16.9-year life expectancy of a 62-year-old man found in Table I.⁵⁷

The part of the expected return attributable to his spouse's lifetime payments is \$153,000. He computes that partial expected return by multiplying the \$18,000 amount paid to his spouse each year (12 months at \$1,500 per month) by the 8.5 years the spouse could expect to receive the payments. He computes the 8.5 years by subtracting his 16.9-year life expectancy under Table I from his and his spouse's 25.4-year joint and survivor life expectancy under Table II.⁵⁸

The total expected return is \$761,400 (the sum of the partial expected returns of \$608,400 and \$153,000 attributable to the retiree and his spouse, respectively). Thus, the retiree's exclusion percentage is 13.1337 percent (determined by dividing the \$100,000 investment in the annuity by the \$761,400 total expected return).

Consequently, \$394.01 of each of the retiree's \$3,000 payments is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 13.1337 percent). If the retiree's spouse survives him, \$197.01 of each of the spouse's \$1,500 payments is nontaxable (the \$1,500 payment multiplied by the exclusion percentage of 13.1337 percent).

Nevertheless, the retiree may *elect* to use tables V and VI (as in Example 1) even though the retiree made all his investment in the annuity on or before June 30, 1986. The retiree makes the election by attaching a statement to his tax return.⁵⁹

Example 3 — Part of Investment Made on or Before June 30, 1986. Assume that in Example 2 the retiree had made only \$30,000 of the \$100,000 investment in the annuity on or before June 30, 1986, but that he elected to make use of the gender-specific tables. In that case, the exclusion percentage for the \$30,000 portion of the investment is 3.9401 percent (the

⁵³Reg. section 1.72-5(b)(2).

⁵⁴Reg. section 1.72-9, tables I, II, V, and VI.

⁵⁵Reg. section 1.72-9, Table V.

⁵⁶Reg. section 1.72-9, Table VI.

⁵⁷Reg. section 1.72-9, Table I.

⁵⁸Reg. section 1.72-9, Table II.

⁵⁹Reg. section 1.72-9.

\$30,000 investment divided by the \$761,400 expected return determined in Example 2). The exclusion percentage for the remaining \$70,000 investment (made after June 30, 1986) is 7.5807 percent (the \$70,000 investment divided by the \$923,400 expected return determined in Example 1).

The combined exclusion percentage is 11.5208 percent (the sum of the two computed exclusion percentages of 3.9401 percent and 7.5807 percent). Thus, \$345.62 of each of the retiree's \$3,000 payments is nontaxable (the \$3,000 payment multiplied by the combined exclusion percentage of 11.5208 percent). If the retiree's spouse survives him, \$172.81 of each of the spouse's \$1,500 payments is nontaxable (the \$1,500 payment multiplied by the combined exclusion percentage of 11.5208 percent).

As noted above, a retiree may have a choice between the gender-based tables I and II and the gender-neutral tables V and VI to determine the nontaxable portion of his annuity payments. Generally, the choice of tables I and II should maximize the nontaxable portion of the annuity payments. However, in some unusual situations, tables V and VI will be more favorable. Thus, a retiree should always compare the tables to determine which table works best for him.

5. Variable annuity contracts. A retiree may have purchased an annuity contract providing variable annuity payments. If so, the retiree computes the nontaxable portion of each variable annuity payment by dividing the investment in the contract by the number of annuity payments the retiree (or retiree and beneficiary) expects to receive. If the variable annuity is for a fixed term, the expected number of payments is simply the number of payments required during the term of the annuity. If the variable annuity is payable for the lifetime of the retiree (or for the lifetimes of the retiree and beneficiary), the expected number of payments is the number of payments per year multiplied by the life expectancy of the retiree (or the retiree and beneficiary).⁶⁰

Example 1 — Entire Investment Made After June 30, 1986. Assume a retiree purchased a variable annuity payable annually over his lifetime. Assume he received his first annual payment on the annuity starting date, and he reaches age 62 on his birthday nearest the annuity starting date. Assume further that his investment in the variable annuity is \$400,000, all invested after June 30, 1986.

Then \$17,391 of each of the retiree's annual annuity payments is nontaxable. He computes the \$17,391 nontaxable amount by dividing his \$400,000 investment in the annuity by his 23-year life expectancy. He determines his 23-year life expectancy by adding the 22.5-year life expectancy for a 62-year-old person (from Table V in the regulations) and the 0.5-year adjustment due to the accelerated annual payment.⁶¹ (Adjustments generally required for nonmonthly annuity payments such as this annual payment are discussed below.)

⁶⁰Reg. section 1.72-2(b)(3)(i), (ii).

⁶¹Reg. section 1.72-9, Table V.

Thus, if the retiree's variable annuity payment were \$36,000 for a particular year, \$18,609 of that annual payment would be taxable to him (the \$36,000 annual payment less the nontaxable portion of \$17,391).

Example 2 — Entire Investment Made on or Before June 30, 1986. Assume that in Example 1 the retiree made all his investment in the annuity contract on or before June 30, 1986, and the contract does not provide any payment options other than the variable life annuity. If so, the retiree may use Table I (the gender-specific table) rather than Table V (the gender-neutral table).

If the retiree uses Table I, \$22,989 of each of the retiree's annual annuity payments is nontaxable. He computes the \$22,989 nontaxable amount by dividing his \$400,000 investment in the annuity by his 17.4-year life expectancy. He determines his 17.4-year life expectancy by adding the 16.9-year life expectancy for a 62-year-old male (from Table I in the regulations) and the 0.5-year adjustment due to the accelerated annual payment.⁶²

Thus, if the retiree's variable annuity payment were \$36,000 for a particular year, \$13,011 of that annual payment would be taxable to him (the \$36,000 annual payment less the nontaxable portion of \$22,989).

Nevertheless, the retiree may *elect* to use Table V (as in Example 1) even though he made all his investment in the annuity on or before June 30, 1986. The retiree makes the election by attaching a statement to his tax return.⁶³

Example 3 — Part of Investment Made on or Before June 30, 1986. Assume that in Example 2 the retiree made only \$100,000 of his \$400,000 investment in the annuity on or before June 30, 1986, but that he elected to make use of the gender-specific table. In that case, the annual nontaxable amount derived from the pre-June 30, 1986, portion of the investment is \$5,747 (the pre-June 30, 1986, investment of \$100,000 divided by the 17.4-year life expectancy computed in Example 2). The annual nontaxable amount for the remaining \$300,000 investment (made after June 30, 1986) is \$13,043 (the \$300,000 investment divided by 23-year life expectancy computed in Example 1).

The combined annual nontaxable amount is \$18,790 (the sum of the two computed nontaxable amounts of \$5,747 and \$13,043). Thus, if the retiree's variable annuity payment were \$36,000 for a particular year, \$17,210 of that annual payment would be taxable to him (the \$36,000 annual payment less the nontaxable portion of \$18,790).⁶⁴

The entire amount of variable annuity payments received in a tax year is nontaxable if the total computed nontaxable amounts for the year exceed the total actual payments for the year. However, the retiree may not

⁶²Reg. section 1.72-9, Table I.

⁶³Reg. section 1.72-9.

⁶⁴See reg. section 1.72-5(b)(7), Example 5, for a more complex example involving a stepped joint and survivor variable annuity with both pre-July 1, 1986, and post-June 30, 1986, investment.

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immediately deduct the excess. Rather, the retiree may elect only to use the excess to increase the nontaxable portions of future variable annuity payments.⁶⁵

Example 4. In Example 1 above, the annual nontaxable amount was \$17,391. Assuming the variable annuity payment for the year was only \$15,000, the retiree would not pay tax on the variable annuity payment.

The excess nontaxable amount for the year is \$2,391 (the total nontaxable amount of \$17,391 less the actual payment of \$15,000). For subsequent tax years, the retiree could elect to spread the excess nontaxable amount over the remaining expected variable annuity payments. That is, assuming the retiree had already received one annual annuity payment, he could expect to receive 22 more annual payments (the 23 total anticipated annual payments determined in Example 1 above less the one payment already received). Thus, he could elect to add to the annual nontaxable amount of \$17,391 an additional nontaxable amount for future tax years of \$109 (the \$2,391 excess nontaxable amount divided by the 22 expected remaining annual payments).

A retiree or his beneficiary makes the election to spread the excess nontaxable amount over future payments by adding a statement to his tax return for the next year he receives a variable annuity payment.⁶⁶

As explained above, a retiree may have a choice between gender-based Table I and gender-neutral Table V to determine the nontaxable portion of variable annuity payments. Generally, the choice of Table I should maximize the nontaxable portion of variable annuity payments for a male, or for a female under age 79. However, a female age 79 or older could generally maximize the nontaxable amount by choosing Table V.

C. Other Less Common Types of Annuities

Examples in the appendix to this article show computations of the nontaxable portions of annuity payments under some less common types of annuities — that is, under annuities providing:

1. payments over the retiree's lifetime or over a fixed period of time, whichever is shorter (a temporary life annuity);
2. payments over the retiree's lifetime, but at a reduced amount after a fixed period of time (a stepped ordinary life annuity); and
3. payments of a level amount over the joint lifetimes of the retiree and a beneficiary, and, after the death of either of them, payments of a lesser amount over the survivor's lifetime (an equally stepped joint and survivor annuity).

D. Quarterly, Semiannual, or Annual Payments

A retiree must adjust the life expectancies found in the actuarial tables if the retiree receives annuity payments quarterly, semiannually, or annually over his lifetime (or

⁶⁵Reg. section 1.72-4(d)(3).

⁶⁶Reg. section 1.72-4(d)(3)(iv).

the lifetimes of the retiree and his beneficiary). The retiree may find this adjustment, as a plus or minus fraction of a year, in the regulations.⁶⁷

E. Increases or Decreases in Annuity Amounts

The exclusion percentage does not change merely because of a planned future increase or decrease in the annuity payment amount.⁶⁸ Rather, a retiree should take into account a planned increase or decrease when he computes the exclusion percentage. Nor does the exclusion percentage change if a nonannuity distribution causes a decrease in the annuity payment amount without changing the period over which the annuity is paid.⁶⁹

However, a retiree or his beneficiary may not apply the exclusion percentage to an increase in an annuity payment amount not anticipated at the annuity starting date.⁷⁰ Instead, he must include in gross income the full amount of the unanticipated increase.⁷¹

F. Multiple Recipients or Multiple Annuities

If two or more persons share in payments from a single annuity, or receive payments from two or more different annuities purchased under a single contract, they must compute a single exclusion percentage that is applicable to all the payments. They compute that exclusion percentage in the usual way. That is, it is equal to the investment in the annuity contract divided by the sum of the expected returns from all the annuities under the contract.⁷²

G. Recovered and Unrecovered Investment

If a retiree (or a retiree and beneficiary) lives long enough to receive the entire expected return under a lifetime annuity, he will have fully recovered the original investment in the contract. At that time, the sum of the amounts previously received and excluded from taxable income will equal the original investment. Thereafter, the retiree or beneficiary must include in gross income all amounts received under the contract.⁷³

If a retiree (or a retiree and beneficiary) does not live long enough to receive the entire expected return under a lifetime annuity, he will not have recovered all the investment in the contract. In that case, the unrecovered investment is generally deductible as an itemized deduction on the final tax return of the last annuitant to die.⁷⁴ The personal representative of the last to die computes the unrecovered investment by subtracting the sum of the nontaxable portions of previous payments from the original investment.⁷⁵

Nevertheless, the unrecovered investment is not deductible if the issuer of the annuity must still make a minimum number of guaranteed payments.⁷⁶ Rather, the

⁶⁷Reg. section 1.72-5(a)(2)(i).

⁶⁸Reg. section 1.72-4(a)(2)(ii), (4).

⁶⁹Reg. section 1.72-11(f)(1).

⁷⁰Reg. section 1.72-4(a)(3).

⁷¹Section 72(e)(2)(A).

⁷²Reg. sections 1.72-5(e)(1), (2), 1.72-2(a)(2).

⁷³Section 72(b)(2).

⁷⁴Sections 72(b)(3)(A), 67(b)(10).

⁷⁵Section 72(b)(4).

⁷⁶Section 72(b)(3)(b).

individual receiving the guaranteed payments may exclude them from gross income until he has recovered the entire remaining investment. Then he must include in gross income the remaining amount of the guaranteed payments.⁷⁷

H. Different Terms or Beneficiaries

If an annuity contract provides one annuity (annuity A) and also provides another annuity (annuity B) with different terms or beneficiaries, the personal representative of a deceased annuitant must determine the unrecovered investment separately for each annuity. He does this by allocating the total investment in the annuity contract between annuity A and annuity B in the ratio of their separate expected returns. That is, the ratio for each annuity equals the expected return for that annuity divided by the sum of the expected returns for both annuities.⁷⁸

The personal representative may then compute the unrecovered investment for either annuity in the usual way. That is, for either annuity, he deducts the sum of the nontaxable amounts previously received under that annuity from the portion of the total investment allocated to that annuity.⁷⁹

IV. Taxation of Nonannuity Distributions

A nonannuity distribution under a personally purchased annuity contract is a distribution not taxable as an annuity payment. Examples of nonannuity distributions include a lump sum distribution, payments guaranteed on the premature death of a life annuitant, and a policyholder dividend.⁸⁰ The total amount of a nonannuity distribution is the amount of cash distributed plus the fair market value of any property distributed. Nonannuity distributions include payments made to third parties if the issuer of the annuity makes the payments on behalf of the retiree or his beneficiary (for example, payments under a garnishment or tax levy).⁸¹

A retiree or his beneficiary must include in gross income the entire amount of most types of nonannuity distributions received *on or after* the annuity starting date. However, a retiree or beneficiary may be able to exclude from gross income a portion of a nonannuity distribution received *before* the annuity starting date provided the annuity contract has unrecovered investment.⁸² More specifically however:

A. Nonannuity Distribution Not Taxed

A retiree or beneficiary need not include in gross income a dividend the issuer of an annuity credits to him

before the annuity starting date to the extent the issuer retains the dividend as a premium.⁸³

B. Nonannuity Distributions Partly Nontaxable

The following types of nonannuity distributions may be nontaxable in whole or in part:

1. A nonannuity distribution received before the annuity starting date that does not redeem or extinguish all rights under the annuity contract.⁸⁴ A retiree or beneficiary generally must include some or all of the distribution in gross income if immediately before the distribution the cash value of the annuity contract exceeded the investment in the contract. In that case, the distribution is includable in gross income to the extent of the lesser of such excess or the amount of the distribution.⁸⁵ (Attempts to reduce the gross income inclusion by designing annuity products having an artificially low cash value at the time of a nonannuity distribution are problematic. The IRS has acted to thwart those attempts in similar contexts.⁸⁶)

For example, assume a retiree's investment in an annuity contract is \$275,000 and the cash value of the contract is \$500,000. Assume the retiree receives a nonannuity distribution of \$300,000 before the annuity starting date. The excess of the \$500,000 value of the annuity contract over the \$275,000 investment then equals \$225,000. Thus, \$225,000 of the \$300,000 distribution is taxable, and \$75,000 of the distribution is a nontaxable return of investment.

(Nevertheless, a retiree or beneficiary may treat a distribution as tax-free to the extent it does not exceed pre-August 14, 1982, unrecovered investment. Distributions in excess of that part of the investment are taxable as described above.⁸⁷)

2. A nonperiodic distribution on or after the annuity starting date that causes a reduction in the annuity payment amount (without changing the overall period for payment of the annuity). The nontaxable portion of the nonperiodic distribution is the amount of the investment in the annuity contract multiplied by a percentage. The percentage equals the amount of the reduction in the

⁸³Section 72(e)(1)(B), (4)(B).

⁸⁴Section 72(e)(2)(B).

⁸⁵Sections 72(e)(2)(B), (3).

⁸⁶The IRS has acted to thwart new IRA annuity products designed to have artificially low cash values subject to taxation when converted to Roth IRAs. (The artificially low cash values subsequently inflate to their proper levels.) Under new regulations, a taxpayer must pay tax on an annuity's FMV on conversion to a Roth IRA, without regard to the annuity's artificial cash value. Reg. section 1.408A-4T, Q&A 14.

⁸⁷Section 72(e)(5)(B). In Rev. Rul. 85-159, 1985-2 C.B. 29, a taxpayer withdrew \$160x from his personally purchased annuity contract when its value was 200x, consisting of pre-August 14, 1982, investment of \$100x and related earnings of \$49x and post-August 13, 1982, investment of \$50x and related earnings of \$1x. The IRS concluded that the \$160x distribution consisted, in order, of pre-August 14, 1982, investment of \$100x, pre-August 14, 1982, earnings of \$49x, post-August 13, 1982, earnings of \$1x, and post-August 13, 1982, investment of \$10x.

⁷⁷Section 72(e)(5)(A), (E).

⁷⁸Reg. sections 1.72-6(b)(1), 1.72-2(a)(2).

⁷⁹Section 72(b)(4).

⁸⁰Section 72(e); reg. sections 1.72-2(b)(2), (3).

⁸¹*Larotonda v. Commissioner*, 89 T.C. 287 (1987); *Vorwald v. Commissioner*, T.C. Memo. 1997-15, Doc 97-830, 97 TNT 6-8.

⁸²Section 72(e)(2). *Caution:* To determine the tax treatment of nonannuity distributions, a retiree must treat as one contract all annuity contracts issued to the retiree by the same company in the same calendar year. Section 72(e)(11)(A)(ii).

annuity payment divided by the amount of the unreduced annuity payment before the reduction.⁸⁸ The exclusion percentage applicable to the continuing annuity payments does not change.⁸⁹

For example, assume a retiree is receiving an annuity of \$4,000 per month. Assume that the issuer of the annuity then makes a lump sum distribution of \$350,000 and reduces the retiree's monthly annuity amount to \$2,500. Assume further that the retiree's investment in the annuity is \$250,000 immediately before the lump sum distribution.

The nontaxable portion of the lump sum distribution is then \$93,750 (37.5 percent of the \$250,000 investment in the contract). The retiree computes the applicable percentage (37.5 percent) by dividing the \$1,500 reduction of the annuity payment by the \$4,000 amount of the old monthly payment.

3. Payments received after the annuity starting date that fully discharge the annuity by refunding some or all of the amount paid for the annuity (for example, payments after the death of an annuitant satisfying an obligation to make a guaranteed minimum number of payments under a lifetime annuity).⁹⁰ The recipient of those payments may treat them as nontaxable until he has recovered the entire remaining investment in the annuity contract. After recovery of the remaining investment, the recipient must include the payments in gross income (including the portion of a payment that is in excess of the last of the remaining investment in the annuity contract).⁹¹

For example, assume that, before the death of a retiree, he received only 40 monthly payments of \$3,000 under an annuity payable over his lifetime. Assume the annuity contract guarantees 60 monthly payments of \$3,000 regardless of how long the retiree lives. Thus, his beneficiary is entitled to an additional 20 payments of \$3,000. Assume further that the remaining investment in the annuity contract is \$16,000 on the date of the retiree's death.

In that case, the first \$16,000 the beneficiary receives is not taxable. Consequently, the beneficiary's first five payments of \$3,000 (totaling \$15,000) are not taxable. An additional \$1,000 of the sixth payment is nontaxable. Thus, the remaining \$2,000 of the sixth payment, and payments 7 through 20, are included in gross income.

4. A distribution that satisfies the entire obligation under an annuity contract.⁹² The nontaxable portion of the distribution is determined in the same way as in item 3 immediately above.⁹³

The IRS has apparently provided no guidance regarding the allocation of the nontaxable amount when two or more beneficiaries share in a single nonannuity distribu-

tion. However, logic and fairness would appear to require each beneficiary to share in the nontaxable amount in proportion to his share of the distribution.

C. Nonannuity Distributions Fully Taxed

Nonannuity distributions are included in gross income in their entirety if they are not one of the types of distributions discussed above (that are nontaxable or only partially includable).⁹⁴

D. Timing Lump Sum Distributions

If a retiree or beneficiary is entitled to an annuity but wishes to withdraw a lump sum and take a lesser annuity, he should generally take the lump sum *on or after* the annuity starting date. As explained above, if the retiree or beneficiary takes the lump sum on or after the annuity starting date (together with a reduced annuity amount over the same period), the lump sum will always consist in part of a ratable portion of the nontaxable investment in the contract (Example 2 above). However, if the retiree or beneficiary takes the lump sum *before* the annuity starting date, the lump sum will generally consist of taxable appreciation in the contract (to the extent thereof) before the nontaxable investment.

V. Investment in the Annuity Contract

A retiree or beneficiary generally determines the retiree's investment in a personally purchased annuity contract as of any specific date by subtracting the nontaxable portions of previous distributions from the amount paid for the contract. More specifically:

1. Cost of the annuity contract. The retiree or beneficiary first determines how much the retiree paid for the contract through premiums or otherwise (including, for example, any investment attributable to loans to the retiree or beneficiary, as discussed below).⁹⁵

2. Previous return of investment. From item 1 above, the retiree or beneficiary subtracts the portion of any previous distributions representing a nontaxable return of investment. For example, the issuer may have made a nonannuity distribution that involved a return of some of the investment.⁹⁶ Alternatively, the retiree or beneficiary may have received annuity payments that were in part a return of investment.⁹⁷

3. Guaranteed annuity payments. Also, the retiree or beneficiary must subtract from item 1 above the value of any guaranteed payments in the nature of a refund of the amount paid for the contract. However, this adjustment applies only in determining the nontaxable portion of annuity payments.⁹⁸ It does not apply in determining the

⁸⁸Reg. section 1.72-11(f)(2). The regulations appear to treat a portion of the contract as completely surrendered or redeemed under section 72(e)(5)(E)(ii).

⁸⁹Reg. section 1.72-11(f)(1).

⁹⁰Section 72(e)(5)(E)(i).

⁹¹Section 72(e)(5)(A), (E).

⁹²Section 72(e)(5)(E)(ii).

⁹³Section 72(e)(5)(A), (E).

⁹⁴Section 72(e)(2)(A). *E.g.*, dividends received on or after the annuity starting date. Reg. section 1.72-11(b)(2). Also, interest paid on a sum held by the issuer of a contract. Section 72(j); reg. section 1.72-14(a).

⁹⁵Sections 72(c)(1)(A), (e)(6)(A); reg. section 1.72-6(a)(1). *See infra* text accompanying notes 108 through 112 for a discussion of investment attributable to loan proceeds.

⁹⁶Sections 72(b)(4)(B), (c)(1)(B), (e)(6)(B); reg. section 1.72-6(a)(1)(ii).

⁹⁷Sections 72(b)(4)(B), (e)(6)(B).

⁹⁸Section 72(c)(2).

nontaxable portion of nonannuity payments or the unrecovered investment in the contract.⁹⁹

Guaranteed payments are the minimum number of payments required under a life annuity regardless of how long the retiree or his beneficiaries live.¹⁰⁰ The retiree or beneficiary computes the value of the guaranteed payments by multiplying the smaller of the total amount of the payments or the amount of the investment in the contract by an actuarial percentage.¹⁰¹

The actuarial percentage depends on the number of years the issuer guarantees the payments and the age of the retiree (and any beneficiaries) on the annuity starting date. The retiree uses the actuarial percentage for a single life annuity in Table VII, Percent Value of Refund Feature (a gender-neutral table in the regulations), if the retiree made his entire investment in the contract after June 30, 1986. If the retiree made the entire investment in the contract on or before June 30, 1986, he may generally use the actuarial percentage found in Table III (a gender-specific table).¹⁰²

If the retiree invested in the contract both before and after June 30, 1986, the retiree or beneficiary may treat the entire investment as made after June 30, 1986. Alternatively, for a single life annuity, the retiree may generally make a special computation using both tables III and VII. Under that computation, the value of the guaranteed payments is the sum of the amount computed by applying the Table III percentage to the pre-July 1, 1986, investment and the amount computed by applying the Table VII percentage to the post-June 30, 1986, investment.¹⁰³

In no event, however, may a retiree use the gender-specific Table III if the retiree's annuity starting date was after June 30, 1986, and the contract provided an option to receive a form of payment other than a life annuity.¹⁰⁴ Note also that if an annuity with guaranteed payments is payable over two or more lifetimes, the retiree or beneficiary must determine the value of the guaranteed payments using the somewhat more complex mathematical formulas set forth in the regulations.¹⁰⁵

The following example illustrates the determination of investment in an annuity for the retiree's lifetime with guaranteed payments:

Example. Assume that in 1987 a retiree purchased an annuity contract for his lifetime for \$100,000. Assume the insurer began making monthly payments of \$500 to him when he retired at age 65. Assume further that the insurer guaranteed 60 annuity payments even if the retiree should die before he receives 60 payments.

For purposes of computing the nontaxable portion of the retiree's annuity payments, his investment in the annuity is \$99,100. He determines the \$99,100 investment

by subtracting the \$900 amount attributable to the 60 guaranteed payments from the \$100,000 cost of the annuity. The \$900 amount is equal to the *lesser* of the \$30,000 total amount of the 60 guaranteed payments or the \$100,000 cost of the annuity — multiplied by 3 percent. Table VII provides this percentage for 60 monthly payments (five years of payments) guaranteed to a person age 65.¹⁰⁶

VI. Other Considerations

A. Conversion of a Lump Sum to an Annuity

A personally purchased contract may provide for a lump sum payable to a retiree on a specified date in full discharge of the contract — with or without an option to convert the lump sum to an annuity. If so, the retiree may avoid immediate taxation of the lump sum amount by electing or agreeing, within 60 days after the specified date, to take an annuity in lieu of the lump sum.¹⁰⁷

B. Loans to Retirees Under Purchased Annuities

A loan to a retiree or beneficiary under a personally purchased annuity contract is taxable as a nonannuity distribution if the retiree obtains the loan before the annuity starting date.¹⁰⁸ An assignment or pledge of his interest in the contract before the annuity starting date is also taxable as a nonannuity distribution.¹⁰⁹ Although the taxable amount of the loan, assignment, or pledge increases the investment in the contract, the amount of the investment is unaffected by the portion of the loan that is a nontaxable return of investment.¹¹⁰

Thereafter, the loan is a "true loan." Thus, repayments of the loan have no effect on the investment in the contract, and the retiree or beneficiary may deduct interest payments made on the loan. If the issuer of the annuity contract offsets the outstanding balance of the loan against a lump sum amount paid on surrender of the annuity contract, the retiree or beneficiary must treat the amount offset as a nonannuity distribution used to repay the loan.¹¹¹ However, in a recent private letter ruling, the IRS allowed a retiree to roll over an amount equal to the offset tax-free into an IRA.¹¹²

C. Tax Withholding on Annuity Contract Payments

The issuer of an annuity contract must generally withhold income tax on the taxable portion of *annuity* payments at rates applicable to wages.¹¹³ The issuer must generally withhold tax on the taxable portion of a *nonannuity* payment at a 10 percent rate.¹¹⁴

In any event, however, the retiree or beneficiary may eliminate income tax withholding on the distributions simply by giving the issuer clear written instructions to

⁹⁹Sections 72(b)(4)(A), (e)(6).

¹⁰⁰Section 72(c)(2).

¹⁰¹Reg. section 1.72-7(b)(3).

¹⁰²Reg. sections 1.72-7, 1.72-9, tables III and VII.

¹⁰³Reg. sections 1.72-6(d)(6), 1.72-7(b)(4), Example 3.

¹⁰⁴Reg. sections 1.72-6(d)(3)(i)(C), 1.72-9.

¹⁰⁵Reg. section 1.72-7(c).

¹⁰⁶Reg. sections 1.72-7, 1.72-9, Table VII.

¹⁰⁷Section 72(h); reg. section 1.72-12.

¹⁰⁸Section 72(e)(4)(A)(i).

¹⁰⁹Section 72(e)(4)(A)(ii).

¹¹⁰Section 72(e)(4)(A).

¹¹¹Section 72(e)(4)(A).

¹¹²LTR 200617037, *Doc 2006-8157, 2006 TNT 83-26* (Jan. 31, 2006).

¹¹³Sections 3405(a)(1), (e)(1)(A)(iii).

¹¹⁴Sections 3405(b)(1), (e)(1)(A)(iii).

do so.¹¹⁵ The election to avoid withholding on the annuity payments remains in effect until revoked.¹¹⁶ Similarly, a separate election to avoid withholding on nonannuity payments remains in effect until revoked.¹¹⁷

D. Income Tax Deductions for Estate Tax Paid

A portion of payments received by a beneficiary under an annuity contract will normally qualify as income in respect of a decedent.¹¹⁸ Thus, the beneficiary may be entitled to itemized deductions for a portion of the estate tax paid on the date-of-death appreciation in the contract.¹¹⁹

E. Exchange of Annuity for New Annuity

A retiree may exchange all or part of his personally purchased annuity contract for a new annuity contract without incurring tax on the exchange.¹²⁰ However, the exchange will be tax-free only if both the old and new contracts are dependent in part on the life expectancy of the retiree¹²¹ and the obligees under the old contract continue to be the obligees under the new contract.¹²² Also, a partial exchange of the old contract may not be

tax-free if the retiree intends to surrender either the old or the new contract after the exchange.¹²³

After December 31, 2009, a retiree may also exchange a personally purchased annuity contract for a long-term care insurance contract without incurring tax. Also, for those years, the tax law will treat an annuity contract with embedded long-term care insurance as if it were a regular annuity contract for purposes of consummating tax-free exchanges.¹²⁴

If the retiree receives cash or other property in addition to the new contract, gain on the old contract is taxable, but only to the extent of the value of the other property or cash received.¹²⁵ The gain may also be subject to the 10 percent penalty tax on early distributions if the retiree is under age 59½ (and no other exception to the penalty applies).¹²⁶ The retiree may not deduct any loss on the old contract.¹²⁷

The retiree determines his investment in the new contract as follows:

1. If the retiree exchanges the entire cash value of the old annuity contract for a new contract (without receiving or paying any other cash or property), the investment in the new contract is the same as in the old contract.¹²⁸
2. If the retiree exchanges only a portion of the cash value of the old contract for the new contract (without paying or receiving any other cash or property), the investment in the new contract equals the investment in the old contract multiplied by a fraction. The fraction is the cash value of the exchanged portion of the old contract divided by the entire cash value of the old contract. The remainder of the investment in the old contract remains with the old contract.¹²⁹
3. If the retiree receives cash or other property in the exchange, the investment in the new contract equals the investment determined in items 1 or 2 above increased by any taxable gain on the exchange and decreased by the value of the other property and cash received.¹³⁰
4. If the retiree pays cash for part of the contract received in the exchange, the investment in the new contract is the sum of the cash paid and the investment determined in items 1 or 2 above.¹³¹

¹¹⁵Sections 3405(a)(2), (b)(2); temp. reg. section 35.3405-1T, Q&A D-22, D-26.

¹¹⁶Temp. reg. section 35.3405-1T, Q&A D-22.

¹¹⁷Temp. reg. section 35.3405-1T, Q&A D-32.

¹¹⁸Section 691; Rev. Rul. 92-47, 1992-1 C.B. 198.

¹¹⁹When a beneficiary receives income in respect of a decedent, he may deduct an amount equal to the "estate tax attributable to all the retiree's income in respect of a decedent" multiplied by a fraction. The fraction is the lesser of the amount of the income in respect of a decedent received by the beneficiary or its estate tax value divided by the estate tax value of all the retiree's income in respect of a decedent. The amount of estate tax attributable to all the retiree's income in respect of a decedent equals the actual estate tax liability less a hypothetical liability computed by excluding net income in respect of a decedent. Net income in respect of a decedent is the estate tax value of income in respect of a decedent less deductions in respect of a decedent. Sections 63(d), 691(c); Rev. Rul. 2005-30, 2005-20 IRB 1015, *Doc 2005-8794*, 2005 *TNT 82-11*.

¹²⁰Section 1035(a)(3); reg. section 1.1035-1. The transfer of all or part of the cash value of an old annuity contract to the new contract will generally qualify as a tax-free exchange. *Conway v. Commissioner*, 111 T.C. No. 20, *Doc 99-734*, 98 *TNT 251-15* (1998), *acq.* 1999-2 C.B. xvi; Rev. Rul. 2003-76, 2003-2 C.B. 355, *Doc 2003-16280*, 2003 *TNT 132-11*. The retiree may even transfer the cash value in several installments. Rev. Rul. 92-43, 1992-1 C.B. 288. The addition of an old annuity contract to an existing annuity contract will also generally qualify as a tax-free exchange. Rev. Rul. 2002-75, 2002-2 C.B. 812, *Doc 2002-25168*, 2002 *TNT 218-80*. After the exchange, the tax law generally treats the new annuity contract as a continuation of the old contract, retaining the history and tax attributes of the old contract. Rev. Rul. 85-159, 1985-2 C.B. 29 (grandfathered treatment of distributions of pre-August 14, 1982, investment and earnings carries over to new contract); Rev. Rul. 92-95, 1992-2 C.B. 43 (new annuity contract treated as purchased on date of purchase of old contract).

¹²¹Section 1035(b).

¹²²Section 1035(a)(3); reg. section 1.1035-1; Rev. Rul. 2003-76, 2003-2 C.B. 355, *Doc 2003-16280*, 2003 *TNT 132-11*.

¹²³Notice 2003-51, 2003-33 IRB 361.

¹²⁴Pension Protection Act of 2006, P.L. 109-280, sections 844(b), (g)(2); section 1035.

¹²⁵Section 1031(b).

¹²⁶Section 72(q).

¹²⁷Section 1031(c).

¹²⁸Section 1031(d); Rev. Rul. 2002-75, 2002-2 C.B. 812, *Doc 2002-25168*, 2002 *TNT 218-80* (merger of old annuity contract into another existing contract, with investment in the merging annuity added to investment in the surviving annuity).

¹²⁹Section 1031(d); Rev. Rul. 2003-76, 2003-2 C.B. 355, *Doc 2003-16280*, 2003 *TNT 132-11*.

¹³⁰Section 1031(d).

¹³¹Section 1031(d); LTR 9820018 (Feb. 11, 1998), *Doc 98-15278*, 98 *TNT 95-51*.

F. After Exchange or Change of Period

A retiree must redetermine the exclusion percentage after a tax-free exchange of annuity contracts or a change in the length of the payment period for an existing annuity. In both cases, the new exclusion percentage is determined as if the contract were a new contract — but by using an investment amount based on the investment carried over from the old contract. If the retiree acquired the new contract in an exchange, the investment is determined as explained under the preceding caption. If the retiree merely changes the payment period of an existing annuity, the investment in the contract generally remains unchanged, unless the change in payment period is accompanied by a lump sum distribution. If there is a lump sum distribution, the retiree treats it as a nonannuity distribution made before the annuity starting date.¹³²

G. Gift of an Annuity Contract

A retiree may transfer a personally purchased annuity contract to the retiree's spouse as a gift (or to a spouse or former spouse incident to divorce) without tax consequence.¹³³ However, if the retiree transfers the contract as a gift to anyone else, the retiree must include in gross income the excess of the cash value of the contract over the investment in the contract.¹³⁴ That excess then increases the investment in the contract that carries over to the transferee.¹³⁵

VII. Retirement Planning With Personal Annuities

In many circumstances, a personally purchased annuity will be a very useful supplement to or substitute for a tax-favored retirement plan or a Roth plan. (As used here, the term "tax-favored retirement plan" includes qualified retirement plans and annuities under sections 401(a) and 403(a), tax-sheltered annuities of tax-exempt organizations under section 403(b), eligible government plans under section 457, and traditional IRAs. A Roth plan is a Roth IRA or designated Roth account that is part of a qualified retirement plan.¹³⁶)

Amounts earned by either a personally purchased annuity contract or a tax-favored retirement plan are generally not taxable until distributed.¹³⁷ However, unlike a tax-favored plan, a personally purchased annuity contract need not make any minimum distributions to a retiree or his spouse during their lifetimes — as long as they do not exercise a payment option and the contract does not otherwise require payment.¹³⁸ The primary disadvantage of the annuity is that, unlike the plan, a retiree must always use after-tax income to fund the annuity. Thus, tax-favored plans are more useful for

taxpayers who wish to defer tax on their compensation earned in high tax rate years to provide income during retirement years that equals or exceeds any required minimum distributions.¹³⁹

As with a personally purchased annuity, a retiree must fund a Roth plan from after-tax income,¹⁴⁰ and the retiree and his spouse may avoid minimum distributions during their lifetimes.¹⁴¹ Thus, a retiree may use either an annuity or a Roth plan to pass tax-deferred funds on to children or other beneficiaries without diminishment by minimum distributions. Of course, under the Roth plan, the beneficiaries may enjoy the additional advantage of receiving distributions entirely tax-free¹⁴² — something the retiree might achieve with an annuity only if the beneficiary is a tax-exempt organization (for example, a qualifying charitable organization).¹⁴³

Despite the relative tax advantages of tax-favored plans and Roth plans, the tax law does substantially limit the amount of contributions that a taxpayer may make to those plans. Thus, personally purchasing an annuity is a good way to provide tax-deferred retirement income if tax-favored plans are not available or if a retiree has already maximized contributions or rollovers to such plans. An annuity is also a good way to pass tax-deferred funds on to children or other beneficiaries if a retiree has already maximized contributions to Roth plans or if Roth plans are not otherwise available. In fact, from a tax

¹³⁹Sections 401(a)(9), 403(b)(10), 408(a)(6), (b)(3), 457(d)(2).

¹⁴⁰Section 408A(c)(1). See also Blankenship, "Conversions of IRAs to Roth IRAs and Roth Recharacterizations," *Journal of Retirement Planning*, Nov.-Dec. 2005 at 11.

¹⁴¹Section 408A(c)(5). A surviving spouse may avoid minimum distribution requirements for a Roth IRA by rolling the funds over to his own Roth IRA. Sections 408(d)(3)(A), (B), (C)(i), (C)(ii)(II); Publication 590. Also, a retiree or surviving spouse may avoid minimum distribution requirements for a designated Roth account by rolling the funds over to his own Roth IRA. Section 402A(c)(3)(A)(ii). See also Blankenship, *supra* note 25.

¹⁴²Sections 408A(d)(1), (2).

¹⁴³If the retiree designates a tax-exempt charitable organization as the beneficiary of an interest in a personally purchased annuity, distributions to the charity after the retiree's death will not be taxable to the retiree's estate or to noncharitable beneficiaries. LTR 199939039, *Doc 1999-31909*, 1999 *TNT* 191-37 (June 30, 1999); LTR 200230018, *Doc 2002-17268*, 2002 *TNT* 145-44 (Apr. 22, 2002). Similarly, the postdeath transfer to the charity of an interest in the annuity will not be subject to income tax unless the transfer is in satisfaction of a fixed-dollar bequest or a nontestamentary obligation. Section 691(a)(2); reg. section 1.691(a)-4. Nor will receipt of the interest or the annuity distributions generally be taxable to the charity (although the 2 percent tax on net investment income may apply to a private foundation). Sections 501(c)(3), 4940(a); LTR 200425027, *Doc 2004-12727*, 2004 *TNT* 119-41 (Feb. 27, 2004). For estate tax purposes, the retiree's estate may generally take a charitable deduction to eliminate any federal estate tax on an annuity interest left to charity. Section 2055(a); LTR 200425027. However, the interest of the charity may have to be carefully structured if the charity is not the sole beneficiary under the annuity contract. Section 2055(e); reg. sections 20.2055-2(e)(1), (2).

¹³²Reg. section 1.72-11(e). For the tax treatment of a nonannuity distribution made before the annuity starting date, see *supra* text accompanying notes 84 through 87.

¹³³Sections 72(e)(4)(C)(ii), 1041(a).

¹³⁴Section 72(e)(4)(C)(i).

¹³⁵Section 72(e)(4)(C)(iii).

¹³⁶Section 402A(b)(2)(A).

¹³⁷Sections 72, 402(a), 403(a)(1), 403(b)(1), 408(d)(1), 408(e)(1), 457(a)(1), 457(g)(2), 501(a).

¹³⁸Sections 72(s)(1), (3). See also Blankenship, *supra* note 25.

standpoint, an annuity might be as effective as a Roth plan if the retiree intends to designate a tax-exempt charity as the beneficiary.

VIII. Summary

Payments under a personally purchased annuity contract are generally taxable as an annuity if certain conditions are satisfied. A retiree or beneficiary must receive the payments at regular intervals over a period of more than one year after the annuity starting date, and the total amount of the payments must be determinable. For a variable annuity, the total amount of the payments need not be determinable if the payment period is determinable.

A retiree generally must pay a 10 percent penalty tax on annuity contract payments received before the retiree reaches age 59½ — unless the retiree is disabled or one of several other exceptions to the penalty applies. Under one exception, the retiree may avoid the penalty by purchasing a single-premium “immediate annuity” paying substantially equal amounts at least annually over the annuity period. Alternatively, the retiree may avoid the penalty by arranging to receive substantially equal payments, at least annually, over his life or life expectancy, or over the joint lives or life expectancies of the retiree and beneficiary. The penalty, however, does not apply in any event to payments received by a beneficiary after the retiree’s death.

Although minimum distribution requirements for annuity contracts are not applicable to a retiree who personally purchases a contract, they do apply to non-spousal beneficiaries. For practical purposes, however, minimum distribution requirements are satisfied for most beneficiaries by providing for distributions over the beneficiary’s life or by providing for complete distribution of the contract benefit within five years of the retiree’s death. Other attempts to avoid the requirements by decreasing initial annuity payments and increasing future payments will probably not be successful. The IRS generally prohibits that type of backloading in analogous situations involving IRAs or qualified retirement plans, except when non-tax-related events justify it.

A retiree or beneficiary determines the nontaxable portion of a nonvariable annuity payment by applying an exclusion percentage. The exclusion percentage is generally equal to the investment in the annuity contract divided by the total expected return on the contract. The total expected return is, in turn, a function of the period the annuity is payable — a period that may consist of a fixed term or the life expectancies of recipients, or both. For purposes of that calculation, the retiree or beneficiary determines life expectancies by reference to actuarial tables in the regulations. Those tables may offer a planning opportunity when a retiree made some of his investment on or before June 30, 1986. In that case, a recipient of annuity payments may be able to use gender-specific tables that minimize the expected return and therefore maximize the exclusion percentage.

A retiree or beneficiary must spread investment in a variable annuity contract over the expected number of annuity payments. The retiree determines the expected number of annuity payments by reference to the fixed terms or life expectancies that are consistent with the

provisions of the contract. Since the annuity payment amounts vary but the nontaxable return of investment is generally constant, it is possible that the investment allocated to the payments in a given tax year will exceed the total amount of the payments for that year. In that event, the retiree or beneficiary should take advantage of the election to spread the excess unused investment over the remaining annuity payments.

If a contract requires the issuer to pay a lump sum on a given date, the retiree or beneficiary may avoid immediate taxation of the lump sum by electing or agreeing within 60 days to take an annuity instead. However, if the retiree or beneficiary is entitled to an annuity but wishes to withdraw a lump sum and take a lesser annuity, he should generally take the lump sum after the annuity starting date. If the retiree or beneficiary takes the lump sum after the annuity starting date (together with a reduced annuity amount), the lump sum will consist in part of a ratable portion of the nontaxable investment in the contract. However, if the retiree or beneficiary takes the lump sum before the annuity starting date, the lump sum will generally consist of taxable appreciation in the contract (to the extent thereof), before nontaxable investment.

A personally purchased annuity is a good vehicle for providing tax-deferred retirement income if tax-favored plans and Roth plans are not available or if a retiree has already maximized contributions or rollovers to those plans. An annuity is also a good way to pass tax-deferred funds on to children or other beneficiaries if a retiree has already maximized contributions to Roth plans or if Roth plans are not otherwise available.

IX. Appendix

This appendix presents examples of computations of the nontaxable portions of annuity payments under some of the less common types of annuities.

A. Temporary Life Annuities

If a retiree purchases a temporary life annuity (an annuity payable over the shorter of the retiree’s lifetime or a fixed term), the nontaxable amount of each annuity payment depends on the retiree’s life expectancy and the length of the fixed term. The retiree determines the expected return on the annuity by multiplying the total amount of the annuity payments the retiree receives each year by the number of years the retiree is expected to receive those payments based on actuarial tables in the regulations. However, the particular table the retiree uses may differ depending on whether he made some or all of the investment in the annuity on or before June 30, 1986.¹⁴⁴

Example 1 — Entire Investment Made After June 30, 1986. Assume a retiree personally purchases a temporary life annuity providing annuity payments of \$3,000 per month for his lifetime or for a term of 25 years, whichever is shorter. Assume further that the investment in the annuity is \$100,000 (all invested after June 30, 1986), and he

¹⁴⁴Reg. sections 1.72-5(a)(3), 1.72-9, tables IV and VIII.

reaches age 75 on his birthday nearest the annuity starting date. (This example is for purposes of illustration only. It is admittedly unlikely a person age 75 would purchase such an annuity.)

The retiree's expected return under the annuity is \$446,400. That expected return is determined by multiplying the total \$36,000 amount paid each year (12 months at \$3,000 per month) by 12.4 years. The 12.4 years is the period that a 75-year-old person with a 25-year temporary life annuity could expect to receive the payments based on regulation Table VIII, Temporary Life Annuities; One Life.¹⁴⁵

Thus, the retiree's exclusion percentage is 22.4014 percent (determined by dividing the \$100,000 investment in the annuity by the \$446,400 expected return). Consequently, \$672.04 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 22.4014 percent).

Example 2 — Entire Investment Made on or Before June 30, 1986. Assume that in Example 1 the retiree made all his investment in the annuity contract on or before June 30, 1986, and the contract does not provide any payment options other than the temporary life annuity. If so, the retiree would ordinarily compute his expected return using Table IV (a gender-specific table in the regulations) rather than Table VIII (a gender-neutral table).

Table IV shows a multiple of 9.6 years for a 75-year-old man with a 25-year temporary life annuity.¹⁴⁶ It follows that the retiree's expected return under the annuity is \$345,600. This expected return is determined by multiplying the total \$36,000 amount paid each year (12 months at \$3,000 per month) by the 9.6-year multiple per Table IV.

Consequently, the retiree's exclusion percentage is 28.9352 percent (determined by dividing the \$100,000 investment in the annuity by the \$345,600 expected return). Thus, \$868.06 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the exclusion percentage of 28.9352 percent).

Nevertheless, the retiree may *elect* to use Table VIII (as in Example 1) even though the retiree made all his investment in the annuity on or before June 30, 1986. The retiree may make the election by attaching a statement to his tax return.¹⁴⁷

Example 3 — Part of Investment Made on or Before June 30, 1986. Assume that in Example 2 the retiree made only \$30,000 of the \$100,000 investment in the annuity on or before June 30, 1986, but that he elected to use the gender-specific table. In that case, the exclusion percentage for the \$30,000 portion of the investment is 8.6805 percent (the \$30,000 investment divided by the \$345,600 expected return computed in Example 2). The exclusion percentage for the remaining \$70,000 investment (made after June

30, 1986) is 15.6810 percent (the \$70,000 investment divided by the \$446,400 expected return computed in Example 1).

The combined exclusion percentage is 24.3615 percent (the sum of the two computed exclusion percentages of 8.6805 percent and 15.6810 percent). Thus, \$730.85 of each \$3,000 payment is nontaxable (the \$3,000 payment multiplied by the combined exclusion percentage of 24.3615 percent).

As noted above, a retiree may have a choice between the gender-based Table IV and the gender-neutral Table VIII to determine the nontaxable portion of annuity payments. Generally, the choice of Table IV should maximize the nontaxable portion of annuity payments for a male — or for a female under age 78. However, a female age 78 or older should compare the tables to determine which table works best for her.

B. Stepped Life Annuities

A retiree may have personally purchased a stepped life annuity (an annuity payable over the retiree's lifetime, but reduced after a stated period of years). If so, the nontaxable amount of each annuity payment depends on the retiree's life expectancy, the length of the stated period, and the different payment levels.

The expected return on the annuity is the sum of two partial expected returns, each based in turn on a different actuarial table. The first partial expected return is equal to the smaller annual amount received after expiration of the stated period multiplied by the life expectancy of the retiree. The second partial expected return is the excess of the larger annual amount received during the stated period over the smaller annual amount subsequently received, multiplied by the number of years the retiree is expected to receive the larger annual amount.¹⁴⁸

Example — Entire Investment Made After June 30, 1986. Assume a retiree personally purchases a stepped life annuity providing annuity payments of \$3,000 per month for his lifetime or for a term of 10 years, whichever is shorter. Also, if he is alive after 10 years, he will receive \$2,000 per month during his remaining lifetime. Assume further that the investment in the annuity is \$100,000 (all invested after June 30, 1986) and the retiree reaches age 75 on his birthday nearest the annuity starting date.

The part of the expected return attributable to the monthly payment of \$2,000 (effectively received throughout the retiree's life) is \$300,000. The retiree computes this partial expected return by multiplying the \$24,000 amount payable each annuity year (12 months at \$2,000 per month) by the 12.5-year life expectancy of the 75-year-old retiree under regulation Table V, Ordinary Life Annuities; One Life.¹⁴⁹

The part of the expected return attributable to the excess monthly payment of \$1,000 (received only as long as the retiree is alive during the 10-year stated period) is

¹⁴⁵Reg. section 1.72-9, Table VIII.

¹⁴⁶Reg. section 1.72-9, Table IV.

¹⁴⁷Reg. section 1.72-9.

¹⁴⁸Reg. section 1.72-5(a)(4).

¹⁴⁹Reg. section 1.72-9, Table V.

\$99,600. The retiree computes that partial expected return by multiplying the \$12,000 excess amount paid each year (12 months at \$1,000 per month) by 8.3 years. The 8.3 years is the period that a 75-year-old person with a 10-year temporary life annuity could expect to receive the payments based on regulation Table VIII, Temporary Life Annuities; One Life.¹⁵⁰

Consequently, the total expected return is \$399,600 (the sum of the partial expected returns of \$300,000 and \$99,600). The exclusion percentage is 25.0250 percent (determined by dividing the \$100,000 investment in the annuity by the \$399,600 total expected return). Thus, 25.0250 percent of each annuity payment is nontaxable.

Assume that, in the example immediately above, the retiree made some or all of his investment in the annuity contract on or before June 30, 1986. Despite the pre-June 30, 1986, investment, it is unlikely the IRS would allow the retiree to use gender-specific actuarial tables in the computation since the annuity he received does not appear to be a life annuity for this purpose. That is, the stepped life annuity appears to include a temporary life annuity that is substantially equivalent to a fixed-term annuity.¹⁵¹

A temporary life annuity is substantially equivalent to a fixed-term annuity if the expected period of payment shown in Table VIII exceeds 50 percent of the maximum term of the temporary life annuity.¹⁵² In this case, the annuity elements received by the retiree include a temporary life annuity starting at age 75, with amounts payable for the shorter of the retiree's lifetime or 10 years. Unfortunately, the 8.3 expected years of payment found in Table VIII (for a 75-year-old man and a 10-year stated period) exceed 50 percent of the 10-year stated period.

C. Equally Stepped Joint and Survivor Annuities

A retiree may have personally purchased an equally stepped joint and survivor annuity (an annuity payable in level amounts over the joint lifetimes of the retiree and his beneficiary and then payable in a lesser amount over the survivor's lifetime). If so, the nontaxable amount of each annuity payment depends on the life expectancies of the retiree and beneficiary and the different amounts of the annuity payments.

The expected return on the annuity is the sum of two partial expected returns, each based in turn on a different actuarial table. The first partial expected return is equal to the smaller annual amount received by the survivor multiplied by the joint and survivor life expectancy of the retiree and beneficiary. The second partial expected return is the excess of the annual amount received during their joint lifetimes over the smaller annual amount received by the survivor, multiplied by the expected joint lifetimes of the retiree and beneficiary (that is, the period both of them are still alive).¹⁵³

The retiree will find the life expectancy tables he must use in the regulations. However, the particular tables the

retiree must use may differ depending on whether the retiree made some or all of the investment in the annuity on or before June 30, 1986.¹⁵⁴

Example 1 — Entire Investment Made After June 30, 1986. Assume a retiree personally purchased an equally stepped joint and survivor annuity providing the retiree and his spouse with payments of \$3,000 per month during their joint lifetimes (that is, as long as both of them are alive).

Assume that, after the death of the first to die, the survivor will receive lifetime annuity payments of \$2,000 per month. Thus, the retiree and spouse will receive an excess amount of \$1,000 per month during their joint lifetimes (\$3,000 per month paid during their joint lifetimes less the \$2,000 per month that is effectively payable throughout the term of the annuity). Assume the investment in the annuity is \$100,000 (all invested after June 30, 1986), and the retiree reaches age 62 and his spouse reaches age 60 on their birthdays nearest the annuity starting date.

The part of the expected return attributable to the monthly payment of \$2,000 (effectively received throughout the term of the annuity) is \$691,200. The retiree computes that partial expected return by multiplying the \$24,000 amount effectively paid each annuity year (12 months at \$2,000 per month) by the 28.8-year joint and survivor life expectancy of the retiree and his spouse under regulation Table VI, Ordinary Joint Lives and Last Survivor Annuities; Two Lives.¹⁵⁵

The part of the expected return attributable to the excess monthly payment of \$1,000 (received only during the joint lifetimes of the retiree and his spouse) is \$214,800. The retiree computes that partial expected return by multiplying the \$12,000 excess amount paid each year (12 months at \$1,000 per month) by the 17.9-year joint life expectancy of the retiree and his spouse under Table VIA, Annuities for Joint Life Only; Two Lives.¹⁵⁶

Consequently, the total expected return is \$906,000 (the sum of the partial expected returns of \$691,200 and \$214,800). The exclusion percentage is 11.0375 percent (determined by dividing the \$100,000 investment in the annuity by the \$906,000 total expected return). Thus, 11.0375 percent of each annuity payment to the retiree or his spouse is nontaxable.

Example 2 — Entire Investment Made on or Before June 30, 1986. Assume that in Example 1 the retiree is male and made all his investment in the annuity contract on or before June 30, 1986. Assume also that the contract does not provide any payment options other than the equally stepped joint and survivor annuity. In that case, the retiree would ordinarily compute the expected return by using tables II and IIA (gender-specific tables in the regulations) rather than Tables VI and VIA (gender-neutral tables).

¹⁵⁰Reg. section 1.72-9, Table VIII.

¹⁵¹Reg. section 1.72-6(d)(3)(iii).

¹⁵²Reg. section 1.72-6(d)(3)(iv).

¹⁵³Reg. section 1.72-5(b)(5).

¹⁵⁴Reg. section 1.72-9, tables II, IIA, VI, and VIA.

¹⁵⁵Reg. section 1.72-9, Table VI.

¹⁵⁶Reg. section 1.72-9, Table VIA.

The part of the expected return attributable to the monthly payment of \$2,000 (effectively received throughout the term of the annuity) is \$609,600. The retiree computes that partial expected return by multiplying the \$24,000 amount effectively paid each annuity year (12 months at \$2,000 per month) by the 25.4-year joint and survivor life expectancy of the retiree and his spouse under Table II.¹⁵⁷

The part of the expected return attributable to the excess monthly payment of \$1,000 (received only during the joint lifetime of the retiree and his spouse) is \$158,400. The retiree computes that partial expected return by multiplying the \$12,000 excess amount paid each year (12 months at \$1,000 per month) by the 13.2-year joint life expectancy of the retiree and his spouse under Table IIA.¹⁵⁸

Consequently, the total expected return is \$768,000 (the sum of the partial expected returns of \$609,600 and \$158,400). The exclusion percentage is 13.0208 percent (determined by dividing the \$100,000 investment in the annuity by the \$768,000 total expected return). Thus, 13.0208 percent of each annuity payment to the retiree or his spouse is nontaxable.

Nevertheless, the retiree may *elect* to use tables VI and VIA (as in Example 1) even though the retiree made all the investment in the annuity on or before June 30, 1986. The retiree may make the election by attaching a statement to his tax return.¹⁵⁹

Example 3 — Part of Investment Made on or Before June 30, 1986. Assume that in Example 2, the retiree made only \$30,000 of the \$100,000 investment in the annuity on or before June 30, 1986, but that he elected to make use of the gender-specific tables. If so, the exclusion percentage for the \$30,000 portion of the investment is 3.9062 percent (the \$30,000 investment divided by the \$768,000 expected return determined in Example 2). The exclusion percentage for the remaining \$70,000 investment (made after June 30, 1986) is 7.7263 percent (the \$70,000 investment divided by the \$906,000 expected return determined in Example 1).

The combined exclusion percentage is 11.6325 percent (the sum of the two computed exclusion percentages of 3.9062 percent and 7.7263 percent). Thus, 11.6325 percent of each annuity payment to the retiree and his spouse is nontaxable.

As noted above, the retiree may have a choice between the gender-based tables II and IIA and the gender-neutral tables VI and VIA to determine the nontaxable portion of his annuity payments. Generally, the choice of tables II and IIA should maximize the nontaxable portion of the annuity payments. However, in some unusual situations, tables VI and VIA may be more favorable. Thus, the retiree should always compare the tables to determine which table works best.

¹⁵⁷Reg. section 1.72-9, Table II.

¹⁵⁸Reg. section 1.72-9, Table IIA.

¹⁵⁹Reg. section 1.72-9.