What is the "Exclusion Ratio," the rule for taxing annuity payments?

The primary rule for taxing non-qualified immediate annuity payments or non-qualified deferred annuities which are distributed in installment payments (i.e."annuitized") is designed to return the owner-purchaser's annuity investment in equal, tax-free amounts over the payment period, and to tax the balance of the amounts received. Each payment, therefore, is part nontaxable return of cost and part taxable income. Any excess interest added to the guaranteed payments is reportable as income for the year received.

An *exclusion ratio* (which may be expressed as a fraction or as a percentage) must be determined for the contract. This exclusion ratio is applied to each annuity payment to find the portion of the payment that is excludable from gross income; the balance of the guaranteed annuity payment is includable in gross income for the year received.[1]

The exclusion ratio of an individual whose annuity starting date is ***after December 31, 1986***, applies to payments received until the payment in which the investment in the contract is fully recovered. In that payment, the amount excludable is limited to the balance of the unrecovered investment. Payments received thereafter are fully includable in income.[2] The exclusion ratio as originally determined at an annuity starting date *before January 1, 1987* applies to all payments received throughout the entire payment period, even if the annuitant has recovered his investment. Thus, it is possible for a long-lived annuitant to receive tax-free amounts that in the aggregate exceed his investment in the contract.

The exclusion ratio for a particular contract is the ratio that the total *investment in the contract* bears to the total *expected return* under the contract. By dividing the investment in the contract by the expected return, the exclusion ratio can be expressed as a percentage (which the regulations indicate should be rounded to the nearest tenth of a percent).[3]

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

If the investment in the contract equals or exceeds the expected return, the full amount of each payment is received tax-free.[4] However, if the annuity starting date is after December 31, 1986, the excludable amount is limited to the investment in the contract; thereafter, any payments are fully includable in income.[5] For life-contingent annuity income, the expected return is calculated using the installment payments and the owner-purchaser's life expectancy (use the appropriate IRS single-life or joint-life annuity table). The total payments to be received to life expectancy are the *expected return* for the exclusion ratio calculation. If the owner-purchaser is still alive at life expectancy, future payments are taxable, as the *investment in the contract* has been fully recovered.

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[1]
IRC Sec. 72(b)(1).
[2]
IRC Sec. 72(b)(2).
[3]
Treas. Reg. §1.72-4(a)(2).
[4]
Treas. Reg. §1.72-4(d)(2).
[5]
IRC Sec. 72(b)(2).

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