

# Publication 939

## General Rule for Pensions and Annuities

(Rev. December 2022)

Volume 1 of 3



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## **Future Developments**

For the latest information about developments related to Pub. 939, such as legislation enacted after it was published, go to [IRS.gov/Pub939](https://www.irs.gov/pub939).

## **Reminders**

**Miscellaneous itemized deductions suspended for tax years 2018 through 2025.** In tax years prior to 2018, user fees

were allowed as miscellaneous itemized deductions subject to 2%-of-adjusted-gross-income (AGI) limit. However, under the Tax Cuts and Jobs Acts (TCJA), miscellaneous itemized deductions are suspended for tax years 2018 through 2025, and therefore user fees aren't allowed for tax years beginning after 2017 and before 2026.

### **Net Investment Income Tax (NIIT).**

Distributions from an annuity under a nonqualified plan are considered net investment income for the purpose of figuring the NIIT. For more information, see the Instructions for Form 8960, Net Investment Income Tax—Individuals, Estates, and Trusts.

## **Introduction**

This publication gives you the information you need to determine the tax treatment of your pension and annuity income under the General Rule. Generally, each of your monthly annuity payments is made up of two parts:

the tax-free part that is a return of your net cost, and the taxable balance.

**What is the General Rule?** The General Rule is one of the two methods used to figure the tax-free part of each annuity payment based on the ratio of your investment in the contract to the total expected return. The other method is the Simplified Method, which is discussed in Pub. 575, Pension and Annuity Income.

**Who must use the General Rule.** Use this publication if you receive pension or annuity payments from:

1. A **nonqualified plan** (such as, a private annuity, a purchased commercial annuity, or a nonqualified employee plan); or
2. A qualified plan **if**:
  - a. Your annuity starting date is **before** November 19, 1996 (and after July 1, 1986), and you don't

qualify to use, or didn't choose to use, the Simplified Method; or

- b. Your annuity starting date is after November 18, 1996, and as of that date you are age 75 or over and the annuity payments are guaranteed for at least 5 years.



*If your annuity starting date was between July 1, 1986, and November 19, 1996, you were able to elect to use the Simplified Method or the General Rule. This choice is irrevocable and applied to all later annuity payments.*

The following are qualified plans.

- A qualified employee plan.
- A qualified employee annuity.
- A tax-sheltered annuity (TSA) plan or contract.

***Simplified Method.*** If you receive pension or annuity payments from a qualified plan and you aren't required to use the General Rule, you must use the Simplified Method to determine the tax-free part of each annuity payment. This method is described in Pub. 575.

Also, if, at the time the annuity payments began, you were at least age 75 and were entitled to annuity payments from a qualified plan with fewer than 5 years of guaranteed payments, you must use the Simplified Method.

### **Topics not covered in this publication.**

Certain topics related to pensions and annuities aren't covered in this publication. They include the following.

- **Simplified Method.** This method is generally used to determine the tax treatment of pension and annuity income from a qualified plan and is covered in Pub. 575. That publication also covers



nonperiodic payments (amounts not received as an annuity) from a qualified pension or annuity plan, rollovers, special averaging and capital gain treatment of lump-sum distributions, and special additional taxes on early distributions, corrective distributions, and excess accumulations (not making required minimum distributions).

- **Individual retirement arrangements (IRAs).** Information on the tax treatment of amounts you receive from an IRA is included in Pub. 590-B, Distributions from Individual Retirement Arrangements (IRAs).
- **Life insurance payments.** If you receive life insurance payments because of the death of the insured person, see Pub. 525, Taxable and Nontaxable Income, for information on the tax treatment of the proceeds.

- **Civil service retirement benefits.** If you are retired from the federal government (regular, phased, or disability retirement) or are the survivor or beneficiary of a federal employee or retiree who died, see Pub. 721, Tax Guide to U.S. Civil Service Retirement Benefits. Pub. 721 covers the tax treatment of federal retirement benefits, primarily those paid under the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). It also covers benefits paid from the Thrift Savings Plan (TSP).
- **Social security and equivalent tier 1 railroad retirement benefits.** For information about the tax treatment of these benefits, see Pub. 915, Social Security and Equivalent Railroad Retirement Benefits. Pub. 575 covers the tax treatment of the non-social security equivalent benefit portion of tier 1 railroad

retirement benefits, tier 2 benefits, vested dual benefits, and supplemental annuity benefits paid by the U.S. Railroad Retirement Board.

- **Tax-sheltered annuity plans (403(b) plans).** If you work for a public school or certain tax-exempt organizations, you may be eligible to participate in a 403(b) retirement plan offered by your employer. Although this publication covers the treatment of benefits under 403(b) plans and discusses in-plan Roth rollovers from 403(b) plans to designated Roth accounts, it doesn't cover other tax provisions that apply to these plans. For that and other information on 403(b) plans, see Pub. 571, Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations.

**Help from the IRS.** If, after reading this publication, you need help to figure the taxable part of your pension or annuity, the

IRS can do it for you for a fee. For information on this service, see *Requesting a Ruling on Taxation of Annuity*, later.

**Comments and suggestions.** We welcome your comments about this publication and your suggestions for future editions.

You can send us comments through [IRS.gov/FormComments](https://www.irs.gov/FormComments). Or you can write to the Internal Revenue Service, Tax Forms and Publications, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224.

Although we can't respond individually to each comment received, we do appreciate your feedback and will consider your comments and suggestions as we revise our tax forms, instructions, and publications.

**Don't** send tax questions, tax returns, or payments to the above address.

***Getting answers to your tax questions.*** If you have a tax question not answered by this publication or the *How To Get Tax Help*

section at the end of this publication, go to the IRS Interactive Tax Assistant page at [IRS.gov/ Help/ITA](https://www.irs.gov/Help/ITA) where you can find topics by using the search feature or viewing the categories listed.

***Getting tax forms, instructions, and publications.*** Go to [IRS.gov/Forms](https://www.irs.gov/Forms) to download current and prior-year forms, instructions, and publications.

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## **Useful Items**

You may want to see:

## Publication

- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **524** Credit for the Elderly or the Disabled
- ☐ **525** Taxable and Nontaxable Income
- ☐ **571** Tax-Sheltered Annuity Plans (403(b) Plans)
- ☐ **575** Pension and Annuity Income
- ☐ **590-A** Contributions to Individual Retirement Arrangements (IRAs)
- ☐ **590-B** Distributions from Individual Retirement Arrangements (IRAs)
- ☐ **721** 721 Tax Guide to U.S. Civil Service Retirement Benefits
- ☐ **915** Social Security and Equivalent Railroad Retirement Benefits

## Form (and Instructions)

- ❑ **1099-R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

See *How To Get Tax Help* for information about getting these publications and forms.

## General Information

Some of the terms used in this publication are defined in the following paragraphs.

***Pension.*** A pension is generally a series of definitely determinable payments made to you after you retire from work. Pension payments are made regularly and are based on such factors as years of service and prior compensation.

***Annuity.*** An annuity is a series of payments under a contract made at regular intervals over a period of more than 1 full year. They can be either fixed (under which you receive a definite amount) or variable (not fixed). You

can buy the contract alone or with the help of your employer.

**Note.** Distributions from pensions and annuities follow the same rules as outlined in this publication unless otherwise noted.

**Types of pensions and annuities.** Pensions and annuities include the following types.

1. **Fixed period annuities.** You receive definite amounts at regular intervals for a specified length of time.
2. **Annuities for a single life.** You receive definite amounts at regular intervals for life. The payments end at death.
3. **Joint and survivor annuities.** The first annuitant receives a definite amount at regular intervals for life. After they die, a second annuitant receives a definite amount at regular intervals for life. The amount paid to the second annuitant may or may not



differ from the amount paid to the first annuitant.

4. **Variable annuities.** You receive payments that may vary in amount for a definite length of time or for life. The amounts you receive may depend upon such variables as profits earned by the pension or annuity funds or cost-of-living indexes, or earnings from a mutual fund.
5. **Disability pensions.** You are under minimum retirement age and receive payments because you retired on disability. If, at the time of your retirement, you were permanently and totally disabled, you may be eligible for the credit for the elderly or the disabled discussed in Pub. 524.

If your annuity starting date is after November 18, 1996, **the General Rule cannot be used** for the following qualified plans.

- A **qualified employee plan** is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries. This plan must meet Internal Revenue Code requirements. It qualifies for special tax benefits, including tax deferral for employer contributions and rollover distributions. However, you must use the General Rule if you were 75 or over and the annuity payments are guaranteed for more than 5 years.
- A **qualified employee annuity** is a retirement annuity purchased by an employer for an employee under a plan that meets Internal Revenue Code requirements.
- A **tax-sheltered annuity** is a special annuity plan or contract purchased for an employee of a public school or tax-exempt organization.

## The General Rule

The General Rule is used to figure the tax treatment of various types of pensions and annuities, including nonqualified employee plans. A **nonqualified employee plan** is an employer's plan that doesn't meet Internal Revenue Code requirements. It doesn't qualify for most of the tax benefits of a qualified plan. Under the General Rule, the tax-free part of each annuity payment is based on the ratio of your *investment in the contract* to the *total expected return*.



*Beginning in 2013, distributions from an annuity under a nonqualified plan are considered net investment income for the purpose of figuring the net investment income tax (NIIT). For more information, see the Instructions for Form 8960, Net Investment Income Tax—Individuals, Estates, and Trusts.*

**Annuity worksheets.** The worksheets found near the end of the text of this publication may be useful to you in figuring the taxable part of your annuity.

**Request for a ruling.** If you are unable to determine the income tax treatment of your pension or annuity, you may ask the IRS to figure the taxable part of your annuity payments. This is treated as a request for a ruling. See *Requesting a Ruling on Taxation of Annuity* near the end of this publication.

**Withholding tax and estimated tax.** Your pension or annuity is subject to federal income tax withholding unless you choose not to have tax withheld. If you choose not to have tax withheld from your pension or annuity, or if you don't have enough income tax withheld, you may have to make estimated tax payments. See Pub. 505.

# Taxation of Periodic Payments

This section explains how the periodic payments you receive under a pension or annuity plan are taxed under the General Rule. Periodic payments are amounts paid at regular intervals (such as weekly, monthly, or yearly) for a period of time greater than 1 year (such as for 15 years or for life). These payments are also known as ***amounts received as an annuity***.



*If you receive an amount from your plan that is a **nonperiodic payment** (amount not received as an annuity), see Taxation of Nonperiodic Payments in Pub. 575.*

In general, you can recover your net cost of the pension or annuity tax free over the period you are to receive the payments. The amount of each payment that is more than the part that represents your net cost is

taxable. Under the General Rule, the part of each annuity payment that represents your net cost is in the same proportion that your investment in the contract is to your expected return. These terms are explained in the following discussions.

## **Investment in the Contract**

Distributions from your pension or annuity plan may include amounts treated as a recovery of your cost (investment in the contract). If any part of a distribution is treated as a recovery of your cost that part is tax free.

In figuring how much of your pension or annuity is taxable under the General Rule, you must figure your investment in the contract.

First, find your net cost of the contract as of the annuity starting date (defined later). To find this amount, you must first figure the total premiums, contributions, or other

amounts paid. This includes the amounts your employer contributed if you were required to include these amounts in income. It also includes amounts you actually contributed (except amounts for health and accident benefits and deductible voluntary employee contributions).

From this **total cost** you subtract:

1. Any refunded premiums, rebates, dividends, or unrepaid loans (any of which weren't included in your income) that you received by the later of the annuity starting date or the date on which you received your first payment.
2. Any additional premiums paid for double indemnity or disability benefits.
3. Any other tax-free amounts you received under the contract or plan before the later of the dates in (1).

**The annuity starting date** is the later of the first day of the first period for which you receive payment under the contract or the date on which the obligation under the contract becomes fixed.

**Example.** On January 1, you completed all your payments required under an annuity contract providing for monthly payments starting on August 1, for the period beginning July 1. The annuity starting date is July 1. This is the date you use in figuring your investment in the contract and your expected return (discussed later).

## **Adjustments**

If any of the following items apply, adjust (add or subtract) your total cost to find your net cost.

**Foreign employment.** If you worked abroad, your cost may include contributions by your employer to the retirement plan, but only if those contributions would be



excludable from your gross income had they been paid directly to you as compensation.

The contributions that apply are:

1. Contributions before 1963 by your employer,
2. Contributions after 1962 by your employer if the contributions would be excludable from your gross income (not including the foreign earned income exclusion) had they been paid directly to you, or
3. Contributions after 1996 by your employer if you performed the services of a foreign missionary (a duly ordained, commissioned, or licensed minister of a church or a lay person) if the contributions would be excludable from your gross income had they been paid directly to you.

***Foreign employment contributions while a nonresident alien.*** In determining your cost, special rules apply if you are a U.S. citizen or resident alien who received distributions from a plan to which contributions were made while you were a nonresident alien. Your contributions and your employer's contributions aren't included in your cost if the contributions:

- Were made based on compensation that was for services performed outside the United States while you were a nonresident alien; and
- Weren't subject to income tax under the laws of the United States or any foreign country, but only if the contribution would have been subject to income tax if paid as cash compensation when the services were performed.

**Death benefit exclusion.** If you are the ***beneficiary*** of a deceased employee (or former employee) who died ***before*** August

21, 1996, you may qualify for a death benefit exclusion of up to \$5,000. The beneficiary of a deceased employee who died after August 20, 1996, won't qualify for the death benefit exclusion.

***How to adjust your total cost.*** If you are eligible, treat the amount of any allowable death benefit exclusion as additional cost paid by the employee. Add it to the cost or unrecovered cost of the annuity at the annuity starting date. See Example 3 under Computation Under the General Rule, later for an illustration of the adjustment to the cost of the contract.

***Net cost.*** Your total cost plus certain adjustments and minus other amounts already recovered before the annuity starting date is your net cost. This is the unrecovered investment in the contract as of the annuity starting date. If your annuity starting date is after 1986, this is the maximum amount that you may recover tax free under the contract.

**Refund feature.** Adjustment for the value of the refund feature is only applicable when you report your pension or annuity under the General Rule. Your annuity contract has a refund feature if:

1. The expected return (discussed later) of an annuity depends entirely or partly on the life of one or more individuals,
2. The contract provides that payments will be made to a beneficiary or the estate of an annuitant on or after the death of the annuitant if a specified amount or a stated number of payments hasn't been paid to the annuitant or annuitants before death, and
3. The payments are a refund of the amount you paid for the annuity contract.

If your annuity has a refund feature, you must reduce your net cost of the contract by the value of the refund feature (figured using Table III or VII at the end of this publication; also see *How To Use Actuarial Tables*, later) to find the investment in the contract.

***Zero value of refund feature.*** For a joint and survivor annuity, the value of the refund feature is **zero** if:

1. Both annuitants are age 74 or younger,
2. The payments are guaranteed for less than  $2\frac{1}{2}$  years, ***and***
3. The survivor's annuity is at least 50% of the first annuitant's annuity.

For a single-life annuity without survivor benefit, the value of the refund feature is **zero** if:

1. The payments are guaranteed for less than  $2\frac{1}{2}$  years; ***and***

2. The annuitant is:

- a. Age 57 or younger (if using the new (unisex) annuity tables),
- b. Age 42 or younger (if male and using the old annuity tables), or
- c. Age 47 or younger (if female and using the old annuity tables).

If you don't meet these requirements, you will have to figure the value of the refund feature, as explained in the following discussion.

**Examples.** Example 1 shows how to figure the value of the refund feature when there is only one beneficiary. Example 2 shows how to figure the value of the refund feature when the contract provides, in addition to a whole life annuity, one or more temporary life annuities for the lives of children. In both examples, the taxpayer elects to use Tables V through VIII. If you need the value of the refund feature for a joint and survivor

annuity, write to the IRS as explained under *Requesting a Ruling on Taxation of Annuity* near the end of this publication.

**Example 1.** At age 65, you bought for \$21,053 an annuity with a refund feature. You will get \$100 a month for life. Your contract provides that if you don't live long enough to recover the full \$21,053, similar payments will be made to your surviving beneficiary until a total of \$21,053 has been paid under the contract. In this case, the contract cost and the total guaranteed return are the same (\$21,053). Your investment in the contract is figured as follows:

Net cost.....	\$21,053
---------------	----------

Amount to be received annually.....	\$1,200
--	---------

Number of years for which payment is guaranteed	17.54
--	-------

(\$21,053 divided by  
\$1,200).....

Rounded to nearest whole  
number of years.... 18

Percentage from Actuarial  
Table VII for age 65 with  
18 years of guaranteed  
payments..... 15%

Value of the refund feature  
(rounded to the nearest  
dollar)—15% of \$21,053... 3,158

**Investment in the  
contract, adjusted for  
value of refund  
feature..... \$17,895**

If the total guaranteed return were less than  
the \$21,053 net cost of the contract, you  
would apply the appropriate percentage from  
the tables to the lesser amount. For example,



if the contract guaranteed the \$100 monthly payments for 17 years to your estate or beneficiary if you were to die before receiving all the payments for that period, the total guaranteed return would be \$20,400 ( $\$100 \times 12 \times 17$  years). In this case, the value of the refund feature would be \$2,856 ( $14\% \times \$20,400$ ) and your investment in the contract would be \$18,197 ( $\$21,053 - \$2,856$ ) instead of \$17,895.

**Example 2.** You died while still employed. Your surviving spouse, age 48, receives \$171 a month for life. Your child, age 9, receives \$50 a month until reaching age 18. Your contributions to the retirement fund totaled \$7,559.45, with interest on those contributions of \$1,602.53. The guarantee or total refund feature of the contract is \$9,161.98 ( $\$7,559.45 + \$1,602.53$ ).

The adjustment in the investment in the contract is figured as follows:

A) Expected return:\*

1)Surviving  
spouse's expected  
return:

Annual annuity  
(\$171 × 12)..... \$2,052

Multiplied by factor  
from Table V  
(nearest age 48)                      34.9    \$71,614.80

2)Child's expected  
return:

Annual annuity  
(\$50 × 12)..... \$600

Multiplied by factor  
from Table VIII

(nearest age 9 for term of 9 years)	<u>9.0</u>	<u>5,400.00</u>
--	------------	-----------------

3)Total expected return.....		<u>\$77,014.80</u>
---------------------------------	--	--------------------

B) Adjustment for refund  
feature:

1)Contributions (net cost).....		<u>\$7,559.45</u>
------------------------------------	--	-------------------

2)Guaranteed amount (contributions of \$7,559.45 plus interest of \$1,602.53).....		\$9,161.98
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3)Minus: Expected return under child's (temporary life) annuity (A(2)).....		<u>5,400.00</u>
--	--	-----------------

4)Net guaranteed  
amount..... \$3,761.98

5)Multiple from Table VII  
(nearest age 48 for 2 years  
duration (recovery of  
\$3,761.98 at \$171 a month  
to nearest whole  
year))..... 0%

6)Adjustment required for  
value of refund feature  
rounded to the nearest  
whole dollar ( $0\% \times$   
\$3,761.98, the smaller of  
B(3) or B(6)).... 0

\* Expected return is the total amount you and other eligible annuitants can expect to receive under the contract. See the discussion of expected return, later in this publication.

**Free IRS help.** If you need to request assistance to figure the value of the refund feature, see *Requesting a Ruling on Taxation of Annuity* near the end of this publication.

## Expected Return

Your expected return is the total amount you and other eligible annuitants can expect to receive under the contract. The following discussions explain how to figure the expected return with each type of annuity.



*A person's age, for purposes of figuring the expected return, is the age at the birthday nearest to the annuity starting date.*

**Fixed period annuity.** If you will get annuity payments for a fixed number of years, without regard to your life expectancy, you must figure your expected return based on that fixed number of years. It is the total amount you will get beginning at the annuity starting date. You will receive specific periodic

payments for a definite period of time, such as a fixed number of months (but not less than 13). To figure your expected return, multiply the fixed number of months for which payments are to be made by the amount of the payment specified for each period.

**Single-life annuity.** If you are to get annuity payments for the rest of your life, find your expected return as follows. You must multiply the amount of the annual payment by a multiple based on your life expectancy as of the annuity starting date. These multiples are set out in actuarial Tables I and V near the end of this publication (see How To Use Actuarial Tables, later).

You may need to adjust these multiples if the payments are made quarterly, semiannually, or annually. See *Adjustments to Tables I, II, V, VI, and VIA* following Table I.

**Example.** You bought an annuity contract that will give you an annuity of \$500 a month for life. If at the annuity starting date, your nearest birthday is 66, the expected return is figured as follows:

Annual payment ( $\$500 \times 12$ months).....	\$6,000
Multiple shown in Table V, age 66.	<u><math>\times 19.2</math></u>
Expected return.....	<u><u>\$115,200</u></u>

If the payments were to be made to you quarterly and the first payment was made 1 full month after the annuity starting date, you would adjust the 19.2 multiple by  $+.1$ . Your expected return would then be \$115,800 ( $\$6,000 \times 19.3$ ).

**Annuity for shorter of life or specified period.** With this type of annuity, you are to get annuity payments either for the rest of your life **or** until the end of a specified period,

whichever period is shorter. To figure your expected return, multiply the amount of your annual payment by a multiple in Table IV or VIII for temporary life annuities. Find the proper multiple based on your sex (if using Table IV), your age at the annuity starting date, and the nearest whole number of years in the specified period.

**Example.** You purchased an annuity this year that will pay you \$200 each month for 5 years or until you die, whichever period is shorter. You were age 65 at your birthday nearest the annuity starting date. You figure the expected return as follows:

Annual payment (\$200 × 12 months) . . . . .	\$2,400
Multiple shown in Table VIII, age 65, 5-year term . . . . .	<u>× 4.9</u>
Expected return . . . . .	<u>\$11,760</u>





*You use Table VIII (not Table IV) because all your contributions were made after June 30, 1986. See Special Elections, later.*

**Joint and survivor annuities.** If you have an annuity that pays you a periodic income for life and after your death provides an ***identical*** lifetime periodic income to your spouse (or some other person), you figure the expected return based on your combined life expectancies. To figure the expected return, multiply the annual payment by a multiple in Table II or VI based on your joint life expectancies. If your payments are made quarterly, semiannually, or annually, you may need to adjust these multiples. See *Adjustments to Tables I, II, V, VI, and VIA* following Table I near the end of this publication.

***Example.*** John bought a joint and survivor annuity providing payments of \$500 a month for his life, and, after his death, \$500 a

month for the remainder of his spouse's life. At John's annuity starting date, his age at his nearest birthday is 70 and his spouse's at the nearest birthday is 67. The expected return is figured as follows:

Annual payment (\$500 × 12 months) . . . . .	\$6,000
Multiple shown in Table VI, ages 67 and 70 . . . . .	<u>× 22.0</u>
Expected return . . . . .	<u>\$132,000</u>

**Different payments to survivor.** If your contract provides that payments to a survivor annuitant will be ***different*** from the amount you receive, you must use a computation that accounts for both the joint lives of the annuitants and the life of the survivor.

**Example 1.** Gerald bought a contract providing for payments to him of \$500 a month for life and, after his death, payments

to his spouse of \$350 a month for life. If, at the annuity starting date, Gerald's nearest birthday is 70 and his spouse is 67, the expected return under the contract is figured as follows:

Combined multiple for Gerald and his spouse, ages 70 and 67 (from Table VI) . . . . .	22.0
Multiple for Gerald, age 70 (from Table V) . . . . .	<u>16.0</u>
Difference: Multiple applicable to his spouse .	<u>6.0</u>
Gerald's annual payment (\$500 × 12) . . . . .	\$6,000
Gerald's multiple . . . . .	<u>16.0</u>
Gerald's expected return .	<u>\$96,000</u>

Spouse's annual payment (\$350 × 12) . . . . .	\$4,200
Spouse's multiple . . . . .	<u>6.0</u>
Spouse's expected return	<u>25,200</u>
<b>Total expected return under the contract . . .</b>	<b><u>\$121,200</u></b>

**Example 2.** Your spouse died while still employed. Under the terms of their employer's retirement plan, you are entitled to get an immediate annuity of \$400 a month for the rest of your life or until you remarry. Your children, Marie and Jean, are each entitled to immediate temporary life annuities of \$150 a month until they reach age 18.

You were 50 years old at the annuity starting date. Marie was 16 and Jean was 14. Using the multiples shown in Tables V and VIII at the end of this publication, the total expected

return on the annuity starting date is \$169,680, figured as follows:

Surviving spouse, age 50  
(multiple from Table V—33.1 ×  
\$4,800 annual payment) . . . . . \$158,880

Marie, age 16 for 2 years duration  
(multiple from Table VIII—2.0 ×  
\$1,800 annual payment) . . . . . 3,600

Jean, age 14 for 4 years duration  
(multiple from Table VIII—4.0 ×  
\$1,800 annual payment) . . . . . 7,200

**Total expected return. . . . . \$169,680**

No computation of expected return is made based on your spouse's age at the date of death because he died before the annuity starting date.

# Computation Under the General Rule

**Note.** Variable annuities use a different computation for determining the exclusion amounts. See Variable annuities, later.

Under the General Rule, you figure the taxable part of your annuity by using the following steps.

**Step 1.** Figure the amount of your investment in the contract, including any adjustments for the refund feature and the death benefit exclusion, if applicable. See Death benefit exclusion, earlier.

**Step 2.** Figure your expected return.

**Step 3.** Divide Step 1 by Step 2 and round to three decimal places. This will give you the ***exclusion percentage***.

**Step 4.** Multiply the ***exclusion percentage*** by the first regular periodic payment. The result is the tax-free part of each pension or annuity payment.

The tax-free part remains the same even if the total payment increases due to variation in the annuity amount such as cost of living increases, or you outlive the life expectancy factor used. However, if your annuity starting date is after 1986, the total amount of annuity income that is tax free over the years can't exceed your net cost.

Each annuitant applies the same exclusion percentage to their initial payment called for in the contract.

**Step 5.** Multiply the tax-free part of each payment (Step 4) by the number of payments received during the year. This will give you the tax-free part of the total payment for the year.



*In the first year of your annuity, your first payment or part of your first payment may be for a fraction of the payment period. This fractional amount is multiplied by your exclusion percentage to get the tax-free part.*

**Step 6.** Subtract the tax-free part from the total payment you received. The rest is the taxable part of your pension or annuity.

**Example 1.** You purchased an annuity with an investment in the contract of \$10,800. Under its terms, the annuity will pay you \$100 a month for life. The multiple for your age (age 65) is 20.0 as shown in Table V. Your expected return is \$24,000 ( $20 \times 12 \times \$100$ ). Your cost of \$10,800, divided by your expected return of \$24,000, equals 45.0%. This is the percentage you won't have to include in income.

Each year, until your net cost is recovered, \$540 (45% of \$1,200) will be tax free and you will include \$660 ( $\$1,200 - \$540$ ) in your



income. If you had received only six payments of \$100 (\$600) during the year, your exclusion would have been \$270 (45% of  $\$100 \times 6$  payments).

**Example 2.** Gerald bought a joint and survivor annuity. Gerald's investment in the contract is \$62,712 and the expected return is \$121,200. The exclusion percentage is 51.7% ( $\$62,712 \div \$121,200$ ). Gerald will receive \$500 a month (\$6,000 a year). Each year, until his net cost is recovered, \$3,102 (51.7% of his total payments received of \$6,000) will be tax free and \$2,898 ( $\$6,000 - \$3,102$ ) will be included in his income. If Gerald dies, his spouse will receive \$350 a month (\$4,200 a year). If Gerald hadn't recovered all of his net cost before his death, his spouse will use the same exclusion percentage (51.7%). Each year, until the entire net cost is recovered, his spouse will receive \$2,171.40 (51.7% of the spouse's payments received of \$4,200) tax free. The

spouse will include \$2,028.60 (\$4,200 – \$2,171.40) on the income tax return.

**Example 3.** Using the same facts as Example 2, earlier under Different payments to survivor, you are to receive an annual annuity of \$4,800 until you die or remarry. Your two children each receive annual annuities of \$1,800 until they reach age 18. Your spouse contributed \$25,576 to the plan. You are eligible for the \$5,000 death benefit exclusion because your spouse died before August 21, 1996.

### **Adjusted Investment in the Contract**

Contributions . . . . .	\$25,576
Plus: Death benefit exclusion . . . .	<u>5,000</u>
Adjusted investment in the contract	<u>\$30,576</u>

The total expected return, as previously figured (in Example 2 under Different payments to survivor), is \$169,680. The exclusion percentage of 18.0% ( $\$30,576 \div \$169,680$ ) applies to the annuity payments you and each of your children receive. Each full year, \$864 ( $18.0\% \times \$4,800$ ) will be tax free to you, and you must include \$3,936 in your income tax return. Each year, until age 18, \$324 ( $18.0\% \times \$1,800$ ) of each of your childrens' payments will be tax free and each must include the balance, \$1,476, as income on their own income tax return.

**Part-year payments.** If you receive payments for only part of a year, apply the exclusion percentage to the first regular periodic payment, and multiply the result by the number of payments received during the year.

If you receive amounts during the year that represent 12 payments, one for each month in that year, and an amount that represents

payments for months in a prior year, apply the exclusion percentage to the first regular periodic payment, and multiply the result by the number of payments the amounts received represent. For instance, if you received amounts during the year that represent the 12 payments for that year plus an amount that represents three payments for a prior year, multiply that amount by the 15 (12 + 3) payments received that year.

If you received a fractional payment, follow Step 5, discussed earlier. This gives you the tax-free part of your total payment.

**Example.** On September 28, Mary bought an annuity contract for \$22,050 that will give her \$125 a month for life, beginning October 30. The applicable multiple from Table V is 23.3 (age 61). Her expected return is \$34,950 ( $\$125 \times 12 \times 23.3$ ). Mary's investment in the contract of \$22,050, divided by her expected return of \$34,950, equals 63.1%. Each payment received will consist of 63.1% return

of cost and 36.9% taxable income, until her net cost of the contract is fully recovered. During the first year, Mary received three payments of \$125, or \$375, of which \$236.63 ( $63.1\% \times \$375$ ) is a return of cost. The remaining \$138.37 is included in income.

**Increase in annuity payments.** The tax-free amount remains the same as the amount figured at the annuity starting date, even if the payment increases. All increases in the installment payments are fully taxable.

However, if your annuity payments are scheduled to increase at a definite date in the future, you must figure the expected return for that annuity using the method described in section 1.72-5(a)(5) of the regulations.

**Example.** Joe's spouse died while still employed and, as the beneficiary, he began receiving an annuity of \$147 per month. In figuring the taxable part, Joe elects to use Tables V through VIII. The cost of the contract was \$7,938, consisting of the sum of

his spouse's net contributions, adjusted for any refund feature. His expected return as of the annuity starting date is \$35,280 (age 65, multiple of 20.0  $\times$  \$1,764 annual payment). The exclusion percentage is  $\$7,938 \div \$35,280$ , or 22.5%. During the year, he received 11 monthly payments of \$147, or \$1,617. Of this amount,  $22.5\% \times \$147 \times 11$  (\$363.83) is tax free as a return of cost and the balance of \$1,253.17 is taxable.

Later, because of a cost-of-living increase, his annuity payment was increased to \$166 per month, or \$1,992 a year ( $12 \times \$166$ ). The tax-free part is still only 22.5% of the annuity payments as of the annuity starting date ( $22.5\% \times \$147 \times 12 = \$396.90$  for a full year). The increase of \$228 ( $\$1,992 - \$1,764$  ( $12 \times \$147$ )) is fully taxable.

**Variable annuities.** For variable annuity payments, figure the amount of each payment that is tax free by dividing your investment in the contract (adjusted for any

refund feature) by the total number of periodic payments you expect to get under the contract.

If the annuity is for a definite period, you determine the total number of payments by multiplying the number of payments to be made each year by the number of years you will receive payments. If the annuity is for life, you determine the total number of payments by using a multiple from the appropriate actuarial table.

***Example.*** Frank purchased a variable annuity at age 65. The total cost of the contract was \$12,000. The annuity starting date is January 1 of the year of purchase. His annuity will be paid, starting July 1, in variable annual installments for his life. The tax-free amount of each payment, until he has recovered his cost of his contract, is:

Investment in the contract..... \$12,000

Number of expected annual  
payments (multiple for age 65 from  
Table V)..... 20

Tax-free amount of each payment  
(\$12,000 ÷ 20)..... \$600

If Frank's first payment is \$920, he includes only \$320 (\$920 – \$600) in his gross income.

If the ***tax-free amount for a year is more than the payments you receive*** in that year, you may choose, when you receive the next payment, to refigure the tax-free part. Divide the amount of the periodic tax-free part that is more than the payment you received by the remaining number of payments you expect. The result is added to the previously figured periodic tax-free part. The sum is the amount of each future payment that will be tax free.



**Example.** Using the facts of the previous example about Frank, assume that after Frank's \$920 payment, he received \$500 in the following year, and \$1,200 in the year after that. Frank doesn't pay tax on the \$500 (second year) payment because \$600 of each annual pension payment is tax free. Since the \$500 payment is less than the \$600 annual tax-free amount, he may choose to refigure his tax-free part when he receives his \$1,200 (third year) payment, as follows:

Amount tax free in second year.....	\$600.00
-------------------------------------	----------

Amount received in second year.....	500.00
-------------------------------------	--------

Difference.....	\$100.00
-----------------	----------

Number of remaining payments after the first 2 payments (age 67, from Table V).....	18.4
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Amount to be added to previously determined annual tax-free part  
(\$100 ÷ 18.4)..... \$5.43

Revised annual tax-free part for third and later years (\$600 + \$5.43)..... \$605.43

**Amount taxable in third year** \$594.57  
(\$1,200 – \$605.43).....

*If you choose to refigure your tax-free amount, you must file a statement with your income tax return stating that you are refiguring the tax-free amount in accordance with the rules of Regulations section 1.72-4(d)(3). The statement must also show the following information.*

1. The annuity starting date and your age on that date.

2. The first day of the first period for which you received an annuity payment in the current year.
3. Your investment in the contract as originally figured.
4. The total of all amounts received tax free under the annuity from the annuity starting date through the first day of the first period for which you received an annuity payment in the current tax year.

## **Exclusion Limits**

Your annuity starting date determines the total amount of annuity income that you can exclude from income over the years.

**Exclusion limited to net cost.** If your annuity starting date is after 1986, the total amount of annuity income that you can exclude over the years as a return of your cost can't exceed your net cost (figured without any reduction for a refund feature).

This is the ***unrecovered investment in the contract*** as of the annuity starting date.

If your annuity starting date is after July 1, 1986, any unrecovered net cost at your (or last annuitant's) death is allowed as an other itemized deduction on the final return of the decedent.

***Example 1.*** Your annuity starting date is after 1986. Your total cost is \$12,500, and your net cost is \$10,000, taking into account certain adjustments. There is no refund feature. Your monthly annuity payment is \$833.33. Your exclusion ratio is 12% and you exclude \$100 a month. Your exclusion ends after 100 months, when you have excluded your net cost of \$10,000. Thereafter, your annuity payments are fully taxable.

***Example 2.*** The facts are the same as in *Example 1*, except that there is a refund feature, and you die after 5 years with no surviving annuitant. The adjustment for the refund feature is \$1,000, so the investment in

the contract is \$9,000. The exclusion ratio is 10.8%, and your monthly exclusion is \$90. After 5 years (60 months), you have recovered tax free only \$5,400 ( $\$90 \times 60$ ). An itemized deduction for the unrecovered net cost of \$4,600 (\$10,000 net cost minus \$5,400) may be taken on your final income tax return. Your unrecovered investment is determined without regard to the refund feature adjustment, discussed earlier, under *Adjustments*.

**Exclusion not limited to net cost.** If your annuity starting date was before 1987, you could continue to take your monthly exclusion for as long as you receive your annuity. If you choose a joint and survivor annuity, your survivor continues to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than your investment in the contract.

# **How To Use Actuarial Tables**

In figuring, under the General Rule, the taxable part of your annuity payments that you are to get for the rest of your life (rather than for a fixed number of years), you must use one or more of the actuarial tables in this publication.

## **Unisex Annuity Tables**

Effective July 1, 1986, the IRS adopted new annuity Tables V through VIII, in which your sex isn't considered when determining the applicable factor. These tables correspond to the old Tables I through IV. In general, Tables V through VIII must be used if you made contributions to the retirement plan after June 30, 1986. If you made no contributions to the plan after June 30, 1986, generally you must use only Tables I through IV. However, if you received an annuity payment after June 30, 1986, you may elect

to use Tables V through VIII (see *Annuity received after June 30, 1986*, later).

## **Special Elections**

Although you generally must use Tables V through VIII if you made contributions to the retirement plan after June 30, 1986, and Tables I through IV if you made no contributions after June 30, 1986, you can make the following special elections to select which tables to use.

**Contributions made both before July 1986 and after June 1986.** If you made contributions to the retirement plan both before July 1986 and after June 1986, you may elect to use Tables I through IV for the pre-July 1986 cost of the contract, and Tables V through VIII for the post-June 1986 cost. (See the examples below.)

***Making the election.*** Attach this statement to your income tax return for the first year in which you receive an annuity:

"I elect to apply the provisions of paragraph (d) of section 1.72-6 of the Income Tax Regulations."

The statement must also include your name, address, social security number, and the amount of the pre-July 1986 investment in the contract.

If your investment in the contract includes post-June 1986 contributions to the plan, and you don't make the election to use Tables I through IV and Tables V through VIII, then you can only use Tables V through VIII in figuring the taxable part of your annuity. You must also use Tables V through VIII if you are unable or don't wish to determine the portions of your contributions that were made before July 1, 1986, and after June 30, 1986.

***Advantages of election.*** In general, a lesser amount of each annual annuity payment is taxable if you separately figure your exclusion ratio for pre-July 1986 and post-June 1986 contributions.





*If you intend to make this election, save your records that substantiate your pre-July 1986 and post-June 1986 contributions. If the death benefit exclusion applies (see discussion, earlier), you don't have to apportion it between the pre-July 1986 and the post-June 1986 investment in the contract.*

The following examples illustrate the separate computations required if you elect to use Tables I through IV for your pre-July 1986 investment in the contract and Tables V through VIII for your post-June 1986 investment in the contract.

**Example 1.** Bill, who is single, contributed \$42,000 to the retirement plan and will receive an annual annuity of \$24,000 for life. Payment of the \$42,000 contribution is guaranteed under a refund feature. Bill is 55 years old as of the annuity starting date. For figuring the taxable part of Bill's annuity, he chose to make separate computations for his

pre-July 1986 investment in the contract of \$41,300, and for his post-June 1986 investment in the contract of \$700.

	<b>Pre-July 1986</b>	<b>Post- June 1986</b>
<hr/>		
<b>A.</b> <i>Adjustment for refund feature</i>		
1) Net cost.....	\$41,300	\$700
2) Annual annuity— \$24,000 (\$41,300/\$42,000 × \$24,000).....	\$23,600	
(\$700/\$42,000 × \$24,000).....		\$400
3) Guarantee under contract.....	\$41,300	\$700
4) No. of years payments	2	2

guaranteed  
(rounded),  $A(3) \div A(2)$ .

5) Applicable percentage from Tables III and VII...	1%	0%
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6) Adjustment for value of refund feature, $A(5) \times$ smaller of $A(1)$ or $A(3)$ .	\$413	\$0
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***B. Investment in the contract***

1) Net cost.....	\$41,300	\$700
2) Minus: Amount in $A(6)$ .....	413	0
3) Investment in the contract.....	\$40,887	\$700

***C. Expected return***

1) Annual annuity receivable.....	\$24,000	\$24,000
2) Multiples from Tables I and V.....	21.7	28.6
3) Expected return, $C(1) \times C(2)$ .....	\$520,800	\$686,400

***D. Tax-free part of annuity***

1) Exclusion ratio as decimal, $B(3) \div$ $C(3)$	0.079	0.001
2) Tax-free part, $C(1) \times D(1)$ .....	\$1,896	\$24

The tax-free part of Bill's total annuity is \$1,920 (\$1,896 + \$24). The taxable part of his annuity is \$22,080 (\$24,000 - \$1,920). If the annuity starting date is after 1986, the exclusion over the years can't exceed the net

cost (figured without any reduction for a refund feature).

***Example 2.*** Al is age 62 at his nearest birthday to the annuity starting date. Al's spouse is age 60 at their nearest birthday to the annuity starting date. The joint and survivor annuity pays \$1,000 per month to Al for life, and \$500 per month to Al's surviving spouse after his death. The pre-July 1986 investment in the contract is \$53,100 and the post-June 1986 investment in the contract is \$7,000. Al makes the election described in *Example 1*.

For purposes of this example, assume the refund feature adjustment is zero. If an adjustment is required, the IRS will figure the amount. See *Requesting a Ruling on Taxation of Annuity* near the end of this publication.

	<b>Pre- July 1986</b>	<b>Post- June 1986</b>
<hr/>		
<b>A. Adjustment for refund feature</b>		
1) Net cost.....	\$53,100	\$7,000
2) Annual annuity— \$12,000 (\$53,100/ \$60,100 × \$12,000)....		\$10,602
(\$7,000/\$60,100 × \$12,000).		\$1,398
3) Guaranteed under the contract.	\$53,100	\$7,000
4) Number of years guaranteed, rounded, A(3) ÷ A(2).....	5	5

5) Applicable percentages.....	0%	0%
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6) Refund feature adjustment, $A(5) \times$ smaller of $A(1)$ or $A(3)$ .....	0	0
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***B. Investment in the contract***

1) Net cost.....	\$53,100	\$7,000
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2) Refund feature adjustment.....	<u>0</u>	<u>0</u>
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3) Investment in the contract adjusted for refund feature.....	<u>\$53,100</u>	<u>\$7,000</u>
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**C. Expected return**

1) Multiple for both annuitants from Tables II and VI..	25.4	28.8
2) Multiple for first annuitant from Tables I and V....	<u>16.9</u>	<u>22.5</u>
3) Multiple applicable to surviving annuitant, subtract C(2) from C(1)..	8.5	6.3
4) Annual annuity to surviving annuitant.....	\$6,000	\$6,000
5) Portion of expected return for surviving	\$51,000	\$37,800



annuitant,  $C(4) \times C(3)$ ....

6) Annual annuity to first annuitant	\$12,000	\$12,000
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7) Plus: Portion of expected return for first annuitant, $C(6) \times C(2)$ .....	<u>\$202,800</u>	<u>\$270,000</u>
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8) Expected return for both annuitants, $C(5) + C(7)$ .....	<u>\$253,800</u>	<u>\$307,800</u>
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***D. Tax-free part of annuity***

1) Exclusion ratio as a decimal, $B(3) \div C(8)$ .....	0.209	0.023
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2) Retiree's tax-free  
part of annuity,

$C(6) \times D(1)$	\$2,508	\$276
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3) Survivor's tax-  
free part of annuity,

$C(4) \times D(1)$ .....	\$1,254	\$138
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The tax-free part of Al's total annuity is \$2,784 (\$2,508 + \$276). The taxable part of his annuity is \$9,216 (\$12,000 – \$2,784). The exclusion over the years can't exceed the net cost of the contract (figured without any reduction for a refund feature) if the annuity starting date is after 1986.

After Al's death, his surviving spouse will apply the same exclusion percentages (20.9% and 2.3%) to their annual annuity of \$6,000 to figure the tax-free part of their annuity.

**Annuity received after June 30, 1986.** If you receive an annuity payment after June 30, 1986 (regardless of your annuity starting

date), you may elect to treat the entire cost of the contract as post-June 1986 cost (even if you made no post-June 1986 contributions to the plan) and use Tables V through VIII. Once made, you can't revoke the election, which will apply to all payments during the year and in any later year.

**Make the election** by attaching the following statement to your income tax return.

"I elect, under section 1.72-9 of the Income Tax Regulations, to treat my entire cost of the contract as a post-June 1986 cost of the plan."

The statement must also include your name, address, and social security number.

You should also indicate you are making this election if you are unable or don't wish to determine the parts of your contributions that were made before July 1, 1986, and after June 30, 1986.

***Disqualifying form of payment or settlement.*** If your annuity starting date is after June 30, 1986, and the contract provides for a disqualifying form of payment or settlement, such as an option to receive a lump sum in full discharge of the obligation under the contract, the entire investment in the contract is treated as post-June 1986 investment in the contract. See Regulations section 1.72-6(d)(3) for additional examples of disqualifying forms of payment or settlement. You can find the Income Tax Regulations in many libraries and at Internal Revenue Service Offices.

## **Worksheets for Determining Taxable Annuity**

**Worksheets I and II.** Worksheets I and II follow for determining your taxable annuity under Regulations Section 1.72-6(d)(6) Election.

**Worksheet I**  
For Determining Taxable Annuity Under Regulations Section 1.72-6(d)(6)  
Election for Single Annuitant With No Survivor Annuity

	Pre-July 1986	Post-June 1986
<b>A. Refund Feature Adjustment</b>		
1) Net cost (total cost less returned premiums, dividends, etc.)		
2) Annual annuity allocation:		
$\frac{\text{Portion of net cost in A(1)} \times \text{annual annuity}}{\text{Net cost}}$		
3) Guaranteed under the contract		
4) Number of years guaranteed, rounded to whole years:		
A(3) divided by A(2)		
5) Applicable percentages* from Tables III and VII		
6) Refund feature adjustment:		
A(5) times lesser of A(1) or A(3)		
<b>B. Investment in the Contract</b>		
1) Net cost:		
A(1)		
2) Refund feature adjustment:		
A(6)		
3) Investment in the contract adjusted for refund feature:		
B(1) minus B(2)		
<b>C. Expected Return</b>		
1) Annual Annuity:		
12 times monthly annuity**		
2) Expected return multiples from Tables I and V		
3) Expected Return:		
C(1) times C(2)		
<b>D. Tax-Free Part of Annuity</b>		
1) Exclusion ratio, as a decimal rounded to 3 places:		
B(3) divided by C(3)		
2) Tax-free part of annuity:		
C(1) times D(1)		

\* If your annuity meets the three conditions listed in *Zero value of refund feature* in *Investment in the Contract*, earlier, both percentages are 0. If not, the IRS will figure the refund feature percentage.

\*\* If the annuity isn't paid monthly, figure the amount to enter by using the total number of periodic payments for the year times the amount of the periodic payment.

Worksheet II

For Determining Taxable Annuity Under Regulations Section 1.72-6(d)(6)

Election for Joint and Survivor Annuity

	Pre-July 1986	Post-June 1986
<b>A. Refund Feature Adjustment</b>		
1) Net cost (total cost less returned premiums, dividends, etc.)		
2) Annual annuity allocation:		
$\frac{\text{Portion of net cost in A(1)}}{\text{Net cost}} \times \text{annual annuity}$		
3) Guaranteed under the contract		
4) Number of years guaranteed, rounded to whole years:		
A(3) divided by A(2)		
5) Applicable percentages*		
6) Refund feature adjustment:		
A(5) times lesser of A(1) or A(3)		
<b>B. Investment in the Contract</b>		
1) Net cost:		
A(1)		
2) Refund feature adjustment:		
A(6)		
3) Investment in the contract adjusted for refund feature:		
B(1) minus B(2)		
<b>C. Expected Return</b>		
1) Multiples for both annuitants, Tables II and VI		
2) Multiple for retiree, Tables I and VI		
3) Multiple for survivor:		
C(1) minus C(2)		
4) Annual annuity to survivor:		
12 times potential monthly rate for survivor**		
5) Expected return for survivor:		
C(3) times C(4)		
6) Annual annuity to retiree:		
12 times monthly rate for retiree**		
7) Expected return for retiree:		
C(2) times C(6)		
8) Total expected return:		
C(5) plus C(7)		
<b>D. Tax-Free Part of Annuity</b>		
1) Exclusion ratio, as a decimal rounded to 3 places:		
B(3) divided by C(8)		
2) Retiree's tax-free part of annuity:		
C(6) times D(1)		
3) Survivor's tax-free part of annuity, if surviving after death of retiree:		
C(4) times D(1)		

\* If your annuity meets the three conditions listed in *Zero value of refund feature* in *Investment in the Contract*, earlier, both percentages are 0. If not, the IRS will figure the refund feature percentage.

\*\* If the annuity isn't paid monthly, figure the amount to enter by using the total number of periodic payments for the year times the amount of the periodic payment.