Part III. Administrative, Procedural, and Miscellaneous

Simplified Exclusion Ratio

Notice 98-2

I. Introduction

This notice replaces Notice 88-118, 1988-2 C.B. 450, to reflect certain changes to § 72 of the Internal Revenue Code of 1986 (the Code) made by the Small Business Job Protection Act of 1996, Pub. L. 104-188 (SBJPA) and by the Taxpayer Relief Act of 1997, Pub. L. 105-34 (TRA '97). Specifically, this notice describes the simplified method provided by § 72(d)(1) for determining the tax-free and taxable portions of certain annuity payments made from qualified plans under § 401(a), employee annuities under § 403(a), and annuity contracts under § 403(b).

In general, this new method applies to an annuity if the annuity starting date is after November 18, 1996. However, see Section V below for a transition rule for annuities with annuity starting dates after November 18, 1996 and before January 1, 1997. Unlike the safe-harbor method in Notice 88-118, the simplified method is required by the Code (rather than optional) and distributees must use this method in order to comply with § 72(d) of the Code as amended by SBJPA and TRA '97. Payors must also use this method to report the taxable portion of the annuity payments on Form 1099-R. The new method does not apply if the annuity starting date is on or before November 18, 1996.

II. Background

Section 402(a)(1) provides that the amount actually distributed to any distributee by an employees' trust described in § 401(a) which is exempt from tax under § 501(a) shall be taxable to the distributee, in the year in which distributed, under § 72 (relating to annuities). Similarly, amounts distributed from employee annuity contracts under § 403(a) and annuity contracts under § 403(b) are taxable to the distributee (in the year in which distributed) under § 72.

Section 72(b) provides that a portion of the annuity payments received in a taxable year may be excluded from gross income as a return of the distributee's investment according to an exclusion ratio determined at the annuity starting date. The numerator of this ratio is the employee's investment in the contract, and the denominator is the expected return.

Section 72(e) provides rules relating to the taxability of amounts not received as annuities. Section 1.72-11(f) of the Income Tax Regulations provides rules for the treatment of a single-sum withdrawal received on or after the annuity starting date.

Notice 88-118 provided a simplified safe harbor method for determining the tax-free portion and taxable portion of certain annuity payments made from qualified plans under § 401(a), employee annuities under § 403(a), and annuity contracts under § 403(b). Under the safe harbor method of Notice 88-118, the exclusion ratio was determined by dividing the distributee's investment in the contract by an expected number of payments based upon the distributee's age. The result represented the tax-free portion of each payment. This safe harbor method could be elected only if the distributee received monthly payments and did not apply to installment payments that were not life contingent.

Section 1403 of SBJPA amended § 72(d) of the Code to require the use of a simplified method of recovering the investment in the contract for most annuity distributions from qualified plans under § 401(a), employee annuities under § 403(a), and § 403(b) annuity contracts. The simplified method of § 72(d) is similar to, but not the same as, the safe-harbor method that was provided in Notice 88-118. Section 1403 of SBJPA also provided a special rule where a single sum is received in connection with the commencement of annuity payments. In such a case, the single- sum payment is treated as if received before the annuity starting date. Generally, the SBJPA changes to § 72(d) of the Code apply to distributions with annuity starting dates after November 18, 1996.

Section 1075 of TRA '97 amended the simplified method of recovering the investment in the contract in § 72(d)(1)(B) of the Code to prescribe a different table if the annuity is payable based on the lives of more than one individual. This new table applies to distributions with annuity starting dates after December 31, 1997. For annuities payable based on the life of only one individual, § 1075 of TRA '97 made no changes in the applicable table under the simplified method described by SBJPA.

III. Simplified Method

A. General

The simplified method provided in § 72(d) of the Code and this notice must be used by distributees to comply with § 72, and by payors to report the taxable portion of annuity distributions on Form 1099-R. If payments are made on a non-monthly basis, the simplified method applies with appropriate adjustments. However, this method does not apply if the annuitant is over age 75 and there are five or more years of guaranteed payments under the annuity.

B. Excluded Amount

Under the simplified method, the distributee recovers his or her investment in the contract in level amounts over the expected number of monthly payments determined from the tables below. The portion of each annuity payment that is excluded from gross income by a distributee for income tax purposes is a level dollar amount determined by dividing the investment in the contract by the set number of annuity payments from the tables below.

$$\frac{\text{Investment}}{\text{Expected Number of Monthly Payments}} = \text{Tax free portion of monthly annuity}$$

C. Expected Number of Monthly Payments

(1) Annuity Starting Dates After November 18, 1996 and Before January 1, 1998

Under the simplified method, for annuity starting dates beginning after November 18, 1996 but before January 1, 1998, the total number of monthly annuity payments expected to be received is based on the primary annuitant's age at the annuity starting date. The same expected number of payments applies to an annuitant whether he or she is receiving a single life annuity or a joint and survivor annuity. The expected number of payments is set forth in the table below.

Age of Primary Annuitant	*Expected Number of Payments*
55 and under	360
56-60	310
61-65	260
66-70	210
71 and over	160

(2) Annuity Starting Dates After December 31, 1997

For annuity starting dates beginning after December 31, 1997, the table used to determine the expected number of payments depends on whether the payments are based on the life of more than one individual. In the case of an annuity payable based on the life of only one individual, the total number of monthly annuity payments expected to be received is based on the annuitant's age at the annuity starting date. An annuity which is payable over the life of one annuitant with a term certain feature is an annuity based on the life of that individual. Similarly, an annuity which is payable over the life of one annuitant with a temporary annuity payable to the annuitant's child until the child reaches an age specified in the plan (not more than age 25) is an annuity based on the life of that individual. The expected number of payments for an annuity based on the life of one individual is set forth in the table below.

Age of Annuitant	*Expected Number of Payments*
55 and under	360
56-60	310
61-65	260
66-70	210
71 and over	160

In the case of an annuity payable based on the life of more than one individual, the total number of monthly annuity payments expected to be received is based on the combined ages of the annuitants at the annuity starting date. If the annuity is payable to a primary annuitant and more than one survivor annuitant, the combined ages of the annuitants is the sum of the age of the primary annuitant and the youngest survivor annuitant. If the annuity is payable to more than one survivor annuitant but there is no primary annuitant, the combined ages of the annuitants is the sum of the age of the oldest survivor annuitant and the youngest survivor annuitant. In addition, any survivor annuitant whose entitlement to payments is contingent on an event other than the death of the primary annuitant is disregarded. The expected number of payments is set forth in the table below.

Combined Ages of Annuitants	*Expected Number of Payments*
110 and under	410
111-120	360
121-130	310
131-140	260
141 and over	210

(3) Term Certain Annuities Without Life Contingencies

In the case of an annuity that does not depend in whole or in part on the life expectancy of one or more individuals, the expected number of payments is the number of monthly annuity payments under the contract.

D. Investment in the Contract

The investment in the contract is defined under § 72(c)(1) as the aggregate premiums or other consideration paid (generally, the aggregate amount of after-tax contributions made to the plan), reduced by amounts received before the annuity starting date that were excluded from gross income. In addition, § 72(c)(2) provides that the investment in the contract must be adjusted to reflect the value of any refund feature. Under § 72(d)(1)(C), as amended by SBJPA, for purposes of the simplified method, the investment in the contract is determined without regard to the adjustment for any refund feature as described in § 72(c)(2).

In certain cases, the investment in the contract could be increased by any death benefit exclusion that is allowed under § 101(b) if the employee death benefits are paid to a survivor in the form of an annuity, other than as a joint and survivor annuity. Section 101(b) was repealed by § 1402 of SBJPA effective with respect to decedents dying after August 20, 1996. Accordingly, in the case of decedents dying after August 20, 1996, surviving beneficiaries no longer are permitted to increase the investment in the contract by the death benefit exclusion.

E. Application of Excluded Amount

The dollar amount determined above, as of the annuity starting date, will be excluded from each monthly annuity payment, even where the amount of the annuity payments change. For example, the amount to be excluded from each annuity payment determined at the annuity starting date remains constant, even if the amount of the annuity payments increases due to cost of living increases, or decreases in the case of a reduced survivor annuity after death of one of the annuitants.

If the amount to be excluded from each payment is greater than the amount of the annuity payment (e.g., because of decreased survivor payments), then each annuity payment will be completely excluded from gross income until the entire investment is recovered. For those distributees with annuity starting dates after December 31, 1986, annuity payments received after the investment is recovered (generally, after the expected number of payments has been received) are fully includible in gross income. If annuity payments cease by reason of death, a deduction for the unrecovered investment in the contract, if any, is allowed on the distributee's last income tax return.

Where two or more annuitants are receiving payments at the same time, each annuitant will exclude from each annuity payment a pro-rata portion of this amount determined according to a ratio, the numerator of which is the amount of the beneficiary's annuity payment, and the denominator of which is the total amount of the monthly annuity payments to all beneficiaries.

F. Adjustments for Non-Monthly Payments

In the case where annuity payments are not made on a monthly basis, under § 72(d)(1)(F) of the Code, an adjustment must be made to take into account the period on the basis of which such payments are made. One way to make this adjustment is to determine the number of expected payments by dividing the applicable expected number of months in the applicable table above by the number of months in each period. Another way (the result of which is equivalent to the first way) is to determine the tax-free portion of a monthly payment using the applicable expected number of months from the applicable table above and then multiply the resulting dollar amount per month by the number of months in each period.

G. Examples

The application of the simplified method is illustrated by the following examples. In all examples, the investment in the contract is stated as the employee's after-tax contributions and with no adjustment for the refund feature.

(i) Example 1

Upon retirement, Employee *A*, age 65, begins receiving retirement benefits in the form of a joint and 50 percent survivor annuity to be paid for the joint lives of *A* and *A's* spouse, age 64. *A's* annuity starting date is January 1, 1997. *A* made $26,000 of after-tax contributions to the plan and has received no distributions prior to the annuity starting date. *A* will receive a monthly retirement benefit of $1,000, and *A's* spouse will receive a monthly survivor benefit of $500 upon *A's* death.

A's investment in the contract is $26,000. Because the annuity starting date is prior to January 1, 1998, the expected number of monthly payments for a distributee who is age 65 is 260. The tax-free portion of each $1,000 monthly annuity payment to *A* is $100, determined by dividing *A's* investment ($26,000) by the expected number of payments (260).

$$\frac{\$26{,}000 \text{ investment}}{260 \text{ monthly payments}} = \$100 \text{ return of investment per month}$$

Upon *A's* death, if *A* has not recovered the full $26,000 investment, *A's* spouse will also exclude $100 from each $500 monthly annuity payment.

Any annuity payments received after the 260 monthly payments have been made will be fully includible in gross income. If *A* and *A's* spouse die before 260 monthly payments have been made, a deduction is allowed for the last income tax return in the amount of the unrecovered investment.

(ii) Example 2

Upon retirement, Employee *B*, age 65, begins receiving retirement benefits in the form of a joint and 50 percent survivor annuity to be paid for the joint lives of *B* and *B's* spouse, age 64. *B's* annuity starting date is January 1, 1998. *B* contributed $26,000 to the plan, and has received no distributions prior to the annuity starting date. *B* will receive a monthly retirement benefit of $1,000 per month, and *B's* spouse will receive a monthly survivor benefit of $500 upon *B's* death.

B's investment in the contract is $26,000. The expected number of monthly payments is 310 for two distributees whose combined ages are 129. The tax-free portion of each $1,000 monthly annuity payment to *B* is $83.87, determined by dividing *B's* investment ($26,000) by the expected number of payments (310).

<u>$26,000 investment</u> = $83.87 return of

310 monthly payments investment per month

Upon *B's* death, if *B* has not recovered the full $26,000 investment, *B's* spouse will also exclude $83.87 from each $500 monthly annuity payment.

Any annuity payments received after the 310 monthly payments have been made will be fully includible in gross income. If *B* and *B's* spouse die before 310 monthly payments have been made, a deduction is allowed for the last income tax return in the amount of the unrecovered investment.

(iii) Example 3.

Upon retirement, Employee *C*, age 66, begins receiving retirement benefits in the form of a joint and 50 percent survivor annuity to be paid for the joint lives of *C* and *C's* spouse, age 65. *C's* annuity starting date is January 1, 1997. *C* contributed $42,000 to the plan, and has received no distributions prior to the annuity starting date. *C* will receive a quarterly retirement benefit of $6,000, and *C's* spouse will receive a quarterly survivor benefit of $3,000 upon *C's* death.

C's investment in the contract is $42,000. Because the annuity starting date is prior to January 1, 1998, the expected number of monthly payments for a distributee who is age 66 is 210. Because *C's* annuity is paid quarterly, the appropriate adjustment is to divide the expected number of payments (210) by the number of months in the period (3), which equals 70. Thus, the tax-free portion of each $6,000 quarterly annuity payment to *C* is $600, determined by dividing *C's* investment ($42,000) by the expected number of quarterly payments (70).

$$\frac{\$42{,}000 \text{ investment}}{70 \text{ quarterly payments}} = \begin{array}{c}\$600 \text{ return of} \\ \text{investment per quarter}\end{array}$$

Alternatively, the appropriate adjustment can be made by dividing $42,000 by 210 and multiplying the resulting $200 per month by the number of months in the period, three (3), which equals a $600 return of investment per quarter.

$$\frac{\$42{,}000 \text{ investment}}{210 \text{ monthly payments}} \times \begin{array}{c}3 \text{ months} \\ \text{per quarter}\end{array} = \begin{array}{c}\$600 \text{ return of} \\ \text{investment per quarter}\end{array}$$

(iv) Example 4.

Upon retirement, Employee *D*, age 57, begins receiving retirement benefits in the form of a joint and 50 percent survivor annuity to be paid for the joint lives of *D* and *D's* spouse, age 57. *D* contributed $31,000 to the plan. *D's* annuity starting date is July 1, 1998. On *D's* annuity starting date, in connection with receiving the first annuity payment, *D* receives a single-sum payment of $10,000. Had the single-sum payment of $10,000 been received prior to *D's* annuity starting date, then under the rules of § 72(e), $2,000 would have been considered as a recovery of *D's* investment in the contract. *D* will receive a monthly retirement benefit of $1,500 per month, and *D's* spouse will receive a monthly survivor benefit of $750 upon *D's* death.

Because the $10,000 is treated as if received before the annuity starting date, *D* will include $8,000 in income as a result of the single-sum payment ($10,000 minus $2,000) and for purposes of determining the tax-free portion of each annuity payment, *D's* investment in the contract is $29,000 (the after-tax contributions to the plan minus the $2,000 portion of the single-sum payment representing the recovery of *D's* investment in the contract). The expected number of monthly payments for two annuitants whose combined ages are 114 is 360. The tax-free portion of each $1,500 monthly annuity payment to *D* is $80.56, determined by dividing *D's* investment ($29,000) by the expected number of payments (360).

$$\frac{\$29{,}000 \text{ investment}}{360 \text{ monthly payments}} = \$80.56 \text{ return of investment per month}$$

Upon *D's* death, if *D* has not recovered the full $29,000 investment, *D's* spouse will also exclude $80.56 from each $750 monthly annuity payment.

Any annuity payments received after the 360 monthly payments have been made will be fully includible in gross income. If *D* and *D's* spouse die before 360 monthly payments have been made, a deduction is allowed for the last income tax return in the amount of the unrecovered investment.

IV. Effective Date

The simplified method described in this notice is generally effective for annuities with annuity starting dates after November 18, 1996. For annuity starting dates after December 31, 1997, if the annuity is payable based on the lives of more than one individual, the simplified method based on the combined ages of the annuitants is to be used.

V. Transition Rule

Some payors and distributees may have continued to use the law in effect prior to SBJPA (including the safe-harbor method contained in Notice 88-118) for annuity starting dates after November 18, 1996 and before January 1, 1997. This notice contains a transition rule for these payors and distributees.

Under this transition rule, for annuities with annuity starting dates after November 18, 1996 and before January 1, 1997, the law in effect prior to SBJPA (including the methodology contained in Notice 88-118) may be used to determine the taxable and tax-free portions of annuity payments received in 1996 and 1997. Accordingly, under this transition rule, payors are not to re-issue Forms 1099-R for 1996 (and 1997, if applicable), and distributees are not to file amended income tax returns for 1996 (and 1997, if applicable), solely because they failed to take into account the changes to § 72(d) of the Code made by SBJPA.

However, under this transition rule, a payor who reports the taxable portion of annuity payments on Form 1099-R must determine the taxable and tax-free portion of annuity payments using the transition method described below. The transition method must be applied to annuity payments made on and after January 1, 1998. However, payors may choose to apply the transition method for annuity payments made on an earlier date (for example, payments made on and after January 1, 1997). Under the transition method, the tax-free portion of each annuity payment made on and after the transition date is determined by dividing the remaining investment in the contract by the remaining number of expected payments. The remaining investment in the contract is the distributee's original investment in the contract as of the annuity starting date, minus the amount of the investment in the contract treated as recovered after the annuity starting date and prior to the transition date. The remaining number of expected monthly payments is the total number of expected monthly payments as of the annuity starting date (as determined by the table in section III(C)(1) of this notice) minus the number of payments made prior to the transition date. Where the payor does not report the taxable portion of annuity payments on Form 1099-R, a distributee who uses the transition rule must determine the taxable and tax-free portions of annuity payments using the transition method described in this paragraph.

(i) Example of Transition Rule

Assume the same facts as in Example 1 except that *A's* annuity starting date is December 1, 1996. The tax-free portion of each $1,000 monthly annuity payment to *A* was determined under Notice 88-118. This tax-free portion was $108.33, calculated as follows.

$$\frac{\$26{,}000 \text{ investment}}{240 \text{ monthly payments}} = \$108.33 \text{ return of investment}$$

The $108.33 was treated as tax-free for the 1996 return. Under the transition rule, this treatment for 1996 is allowed. However, the taxable and tax-free portions must be redetermined using the transition method with a transition date of January 1, 1998, or earlier.

Assume that *A* uses January 1, 1997 as the transition date. For annuity payments received after December 31, 1996, determine the tax-free portion of each $1,000 annuity payment by dividing the remaining investment in the contract by the remaining number of expected payments as of the transition date, determined in accordance with § 72(d) and this notice. Accordingly, the tax-free portion of each $1,000 payment received in 1997 and later years is

$99.97, determined as follows.

$$\frac{\$25{,}891.67\ (\$26{,}000 \text{ minus } \$108.33)}{259 \text{ payments } (260 \text{ minus } 1)} = \$99.97 \text{ return of investment}$$

Under this method, the total amount of annuity payments that is tax-free is $26,000.

VI. Effect on Other Documents

Notice 88-118 is obsoleted.

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans Division. For further information please contact the Employee Plans Division's taxpayer assistance telephone service between the hours of 2:30 p.m. and 3:30 p.m. Eastern time, Monday through Thursday on (202) 622-6076 (not a toll-free call). Mr. Newman's telephone number is (202) 622-6262 (also not a toll-free call).