

## § 1.72-11

## 26 CFR Ch. I (4-1-04 Edition)

starting date shall be determined for the transferee without regard to the annuity starting date, if any, of the transferor. In determining the transferee's investment in the contract, the aggregate amount of premiums or other consideration paid shall be reduced by all amounts received by the transferee before the receipt of an amount as an annuity or before the annuity starting date, whichever is the later, to the extent that such amounts were excludable from his gross income under the applicable income tax law at the time of receipt. For the treatment of amounts received by the transferee subsequent to both the annuity starting date and the date of receipt of a payment as an annuity, but not received as annuity payments, see § 1.72-11. For a limitation on adjustments to the basis of annuity contracts sold, see section 1021.

(b) In the case of a transfer of such a contract without valuable consideration, the annuity starting date and the expected return under the contract shall be determined as though no such transfer had taken place. See paragraph (b) of § 1.72-4. The transferee shall include the aggregate of premiums or other consideration paid or deemed to have been paid by his transferor in the aggregate of premiums or other consideration as though paid by him. In determining the transferee's investment in the contract, the transferee's aggregate amount of premiums or other consideration paid (as so found) shall be reduced by all amounts either received or deemed to have been received by himself or his transferor before the annuity starting date, or before the date on which an amount is first received as an annuity, whichever is the later, to the extent that such amounts were excludable from the gross income of the actual recipient under the applicable income tax law at the time of receipt. For treatment of amounts received subsequent to both the above dates by such transferee, but not received as annuity payments, see § 1.72-11.

### **§ 1.72-11 Amounts not received as annuity payments.**

(a) *Introductory.* (1) This section applies to amounts received under a con-

tract to which section 72 applies if either:

(i) Paragraph (b) of § 1.72-2 is inapplicable to such amounts.

(ii) Paragraph (b) of § 1.72-2 is applicable but the annuity payments received differ either in amount, duration, or both, from those originally provided under the contract, or

(iii) Paragraph (b) of § 1.72 is applicable, but such annuity payments are received by a beneficiary after the death of an annuitant (or annuitants) in full discharge of the obligation under the contract and solely because of a guarantee.

The payments referred to in subdivision (i) of this subparagraph include all amounts other than "amounts received as an annuity" as that term is defined in paragraphs (b) (2) and (3) of § 1.72-2. If such amounts are received as dividends or payments in the nature of dividends, or as a return of premiums, see paragraph (b) of this section. If such amounts are paid in full discharge of the obligation under the contract and are in the nature of a refund of the consideration, see paragraph (c) of this section. If such amounts are paid upon the surrender, redemption, or maturity of the contract, see paragraph (d) of this section. The payments referred to in subdivision (ii) of this subparagraph include all annuity payments which are paid as the result of a modification or an exchange of the annuity obligations originally provided under a contract for different annuity obligations (whether or not such modification or exchange is accompanied by the payment of an amount to which subdivision (i) of this subparagraph applies). If the duration of the new annuity obligations differs from the duration of the old annuity obligations, paragraph (e) of this section applies to the new annuity obligations and paragraph (d) of this section applies to any lump sum payment received. If, however, the duration of the new annuity obligations is the same as the duration of the old obligations, paragraph (f) of this section applies to the new obligations and to any lump sum received in connection therewith. The annuity payments referred to in subdivision (iii) of this subparagraph are annuity payments which are made to a beneficiary after

the death of annuitant (or annuitants) in full discharge of the obligations under a contract because of a provision in the contract requiring the payment of a guaranteed amount or minimum number of payments for a fixed period; see paragraph (c) of this section.

(2) The principles of this section apply, to the extent appropriate thereto, to amounts paid which are taxable under section 72 (except, for taxable years beginning before January 1, 1964, section 72(e)(3)) in accordance with sections 402 and 403 and the regulations thereunder. However, if contributions used to purchase the contract include amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the rules of this section are modified by the rules of paragraph (b) of §1.72-17. Further, in applying the provisions of this section, the aggregate premiums or other consideration paid shall not include contributions on behalf of self-employed individuals to the extent that deductions were allowed under section 404 for such contributions. Nor, shall the aggregate of premiums or other consideration paid include amounts used to purchase life, accident, health, or other insurance protection for an owner-employee. See paragraph (b)(4) of §1.72-16 and paragraph (c) of §1.72-17. The principles of this section also apply to payments made in the manner described in paragraph (b)(3)(i) of §1.72-2.

(b) *Amounts received in the nature of dividends or similar distributions.* (1) If dividends (or payments in the nature of dividends or a return of premiums or other consideration) are received under a contract to which section 72 applies and such payments are received before the annuity starting date or before the date on which an amount is first received as an annuity, whichever is the later, such payments are includible in the gross income of the recipient only to the extent that they, taken together with all previous payments received under the contract which were excludable from the gross income of the recipient under the applicable income tax law, exceed the aggregate of premiums or other consideration paid or deemed to have been paid by the recipient. Such payments shall also be sub-

tracted from the consideration paid (or deemed paid) both for the purpose of determining an exclusion ratio to be applied to subsequent amounts paid as an annuity and for the purpose of determining the applicability of section 72(d) and §1.72-13, relating to employee contributions recoverable in three years.

(2) If dividends or payments in the nature of dividends are paid under a contract to which section 72 applies and such payments are received on or after the annuity starting date or the date on which an amount is first received as an annuity, whichever is later, such payments shall be fully includible in the gross income of the recipient. The receipt of such payments shall not affect the aggregate of premiums or other consideration paid nor the amounts contributed or deemed to have been contributed by an employee as otherwise calculated for purposes of section 72. Since the investment in the contract and the expected return are not affected by a payment which is fully includible in the gross income of the recipient under this rule, the exclusion ratio will not be affected by such payment and will continue to be applied to amounts received as annuity payments in the future as though such payment had not been made. This subparagraph shall apply to amounts received under a contract described in paragraph (b)(3)(i) of §1.72-2 to the extent that the amounts received exceed the portion of the investment in the contract allocable to each taxable year in accordance with paragraph (d)(3) of §1.72-4. Hence, such excess is fully includible in the gross income of the recipient.

(c) *Amounts received in the nature of a refund of the consideration under a contract and in full discharge of the obligation thereof.* (1) Any amount received under a contract to which section 72 applies, if it is at least in part a refund of the consideration paid, including amounts payable to a beneficiary after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain or with a minimum amount which must be paid in any event, shall be considered an amount received in the nature of a refund of

the consideration paid for such contract. If such an amount is in full discharge of an obligation to pay a fixed amount (whether in a lump sum or otherwise) or to pay amounts for a fixed number of years (including amounts described in paragraph (b)(3)(i) of § 1.72-2), it shall be included in the gross income of the recipient only to the extent that it, when added to amounts previously received under the contract which were excludable from gross income under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 73(e)(2)(A). This paragraph shall not apply if the total of the amounts to be paid in discharge of the obligation can in any event exceed the total of the annuity payments which would otherwise fully discharge the obligation. For rules to be applied in such a case, see paragraph (e) of this section.

(2) The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example (1).* A, a male employee, retired on December 31, 1954, at the age of 60. A life annuity of \$75 per month was payable to him beginning January 31, 1955. The annuity contract guaranteed that if A did not live for at least ten years after his retirement his beneficiary, B, would receive the monthly payments for any balance of such ten-year period which remained at the date of A's death. Under section 72, A was deemed to have paid \$3,600 toward the cost of the annuity. A lived for five years after his retirement receiving a total of \$4,500 in annuity payments. After A's death, B began receiving the monthly payments of \$75 beginning with the January 31, 1960 payment. B will exclude such payments from his gross income throughout 1960, 1961, and 1962, and will exclude only \$18 of the first payment in 1963 from his gross income for that year. Thereafter, B will include the entire amount of all such payments in his gross income for the taxable year of receipt. This result is determined as follows:

A's investment in the contract (unadjusted) .....	\$3,600
Multiple from Table III of § 1.72-9 for male, age 60, where duration of guaranteed amount is 10 years (percent) .....	11
Subtract value of the refund feature to the nearest dollar (11 percent of \$3,600) .....	396

Investment in the contract adjusted for the present value of the refund feature without discount for interest .....	3,204
Aggregate of premiums or other consideration paid .....	3,600
A's exclusion ratio (\$3,204÷\$16,380 [ \$900×18.2]) (percent) .....	19.6
Subtract amount excludable during five years A received payments (19.6 percent of \$4,500 [ \$900×5]) .....	882
Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72(e) .....	2,718

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipient is 36<sup>25</sup>/<sub>100</sub> (\$2,718÷\$75) and B will exclude the payments from his gross income for three years, then exclude only \$18 of the first payment for the fourth year from his gross income, and thereafter include the entire amount of all payments he receives in his gross income.

*Example (2).* The facts are the same as in example (1), except that B, the beneficiary, elects to receive \$50 per month for his life in lieu of the payments guaranteed under the original contractual obligation. Since such amounts will be received as an annuity and may, because of the length of time B may live, exceed the amount guaranteed, they are not amounts to which this paragraph applies. See paragraph (e) of this section.

*Example (3).* The facts are the same as in example (1), except that B, the beneficiary, elects to receive the remaining guaranteed amount in installments which are larger or smaller than the \$75 per month provided until, under the terms of the contract, the guaranteed amount is exhausted. The rule of subparagraph (1) of this paragraph and the computation illustrated in example (1) apply to such installments since the total of such installments will not exceed the original amount guaranteed to be paid at A's death in any event.

*Example (4).* C pays \$12,000 for a contract providing that he is to be paid an annuity of \$1,000 per year for 15 years. His exclusion ratio is therefore 80 percent (\$12,000÷\$15,000). He directs that the annuity is to be paid to D, his beneficiary, if he should die before the full 15-year period has expired. C dies after 5 years and D is paid \$1,000 in 1960. D will include \$200 (\$1,000—\$800 [80 percent of \$1,000]) in his gross income for the taxable year in which he receives the \$1,000 since section 72(e) and this section do not apply to the annuity payments made in accordance with the

provisions and during the term of the contract. D will continue with the same exclusion ratio used by C (80 percent).

*Example (5).* In 1954, E paid \$50,000 into a fund and was promised an annual income for life the amount of which would depend in part upon the earnings realized from the investment of the fund in accordance with an agreed formula. The contract also specified that if E should die before ten years had elapsed, his beneficiary, F, would be paid the amounts determined annually under the formula until ten payments had been received by E and F together. E died in 1960, having received five payments totaling \$30,000. Assuming that \$22,000 of this amount was properly excludable from E's gross income prior to his death, F will exclude from his gross income the payments he receives until the taxable year in which his total receipts from the fund exceed \$28,000 (\$50,000 - \$22,000). F will include any excess over the \$28,000 in his gross income for that taxable year. Thereafter, F will include in his gross income the entire amount of any payments made to him from the fund.

*Example (6).* Assume the facts are the same as in example (1), except that the total investment in the contract is made after June 30, 1986, that A is to receive payments under the life annuity contract beginning on January 31, 1987, and that B will begin to receive the monthly payments on January 31, 1992. B will exclude the \$75 monthly payments from gross income throughout 1992, 1993, and 1994. B will exclude only the first two monthly payments and \$21 of the third monthly payment in 1995. This is determined as follows:

A's investment in the contract (unadjusted) .....	\$3,600
Multiple from Table VII, age 60, 10 years (percent) .....	4
Subtract value of the refund feature (4 percent of \$3,600) .....	\$144
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Investment in the contract adjusted for the present value of the refund feature without discount for interest .....	\$3,456
Aggregate of premiums or other consideration paid .....	\$3,600.00
A's exclusion ratio ( $\$3,456 \div \$21,780$ [ $\$900 \times 24.2$ ]) (percent) .....	15.9
Subtract amount excludable during five years A received payments (15.9 percent of $\$4,500$ [ $\$900 \times 5$ ]) .....	\$715.50
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Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72(e) ..	\$2,884.50

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipi-

ent is 38 23/50 ( $\$2,884.50 \div 75$ ) and B will exclude the payments from gross income for three years, then exclude only the first two monthly payments and \$34.50 of the third. Thereafter B shall include the entire amount of all payments received in gross income.

(3) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received in full discharge of the obligation is the same person as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72-10. For the limit on the tax, for taxable years beginning before January 1, 1964, attributable to the receipt of a lump sum to which this paragraph applies, see paragraph (g) of this section.

(d) *Amounts received upon the surrender, redemption, or maturity of a contract.* (1) Any amount received upon the surrender, redemption, or maturity of a contract to which section 72 applies, which is not received as an annuity under the regulations of paragraph (b) of § 1.72-2, shall be included in the gross income of the recipient to the extent that it, when added to amounts previously received under the contract and which were excludable from the gross income of the recipient under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72(e)(2)(B). If amounts are to be received as an annuity, whether in lieu of or in addition to amounts described in the preceding sentence, such amounts shall be included in the gross income of the recipient in accordance with the provisions of paragraph (e) or (f) of this section, whichever is applicable. The rule stated in the first sentence of this paragraph shall not apply to payments received as an annuity or otherwise after the date of the first receipt of an amount as an annuity subsequent to the maturity, redemption, or surrender of the original contract. If amounts are so received and are other than amounts received as an annuity, they are includible in the gross income of the recipient. See section 72(e)(1)(A) and paragraph (b)(2) of this section.

(2) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received upon the surrender, redemption, or maturity of the contract is the same as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72-10. For the limit on the amount of tax, for taxable years beginning before January 1, 1964, attributable to the receipt of certain lump sums to which this paragraph applies, see paragraph (g) of this section.

(e) *Periodic payments received for a different term.* If, after the date on which an amount is first received as an annuity under a contract to which section 72 applies, the terms of the contract are modified or the annuity obligations are exchanged so that periodic payments are to be received for a different term than originally provided under the contract (whether or not accompanied by the receipt of a lump sum to which paragraph (d) of this section applies), the rules of this paragraph shall apply to such payments. Hence, the provisions of section 72(e) and paragraphs (b), (c), (d), and (f) of this section are inapplicable for the purpose of determining the includibility of such payments in gross income and the general principles of section 72 with respect to the use of an exclusion ratio shall be applied to such payments as if they were provided under a new contract received in exchange for the contract providing the original annuity payments. If such payments are received as the result of the surrender, redemption, or discharge of a contract to which section 72 applies, they shall be considered to be received as an annuity under a contract exchanged for the contract whose redemption, surrender, or discharge was involved. For the purpose of determining the extent to which the payments so received are to be included in the gross income of the recipient, an exclusion ratio shall be determined for such contract as of the later of January 1, 1954, or the first day of the first period for which an amount is received as an annuity

thereunder, whichever is the later. See paragraph (b) of § 1.72-4. In determining the investment in the contract for this purpose, any lump sum amount received at the time of the exchange shall not be considered an amount to which paragraph (a)(2) of § 1.72-6 applies. However, such lump sum shall be subtracted from the aggregate of premiums or other consideration paid to the extent it is excludable as an amount not received as an annuity under this section as if it were an amount received before the annuity starting date of the contract obtained in exchange.

(f) *Periodic payments received for the same term after a lump sum withdrawal.* (1) If, after the date of the first receipt of a payment as an annuity, the annuitant receives a lump sum and is thereafter to receive annuity payments in a reduced amount under the contract for the same term, life, or lives as originally specified in the contract, a portion of the contract shall be considered to have been surrendered or redeemed in consideration of the payment of such lump sum and the exclusion ratio originally determined for the contract shall continue to apply to the amounts received as an annuity without regard to the fact that such amounts are less than the original amounts which were to be paid periodically. The lump sum shall be includible in the gross income of the recipient in accordance with the provisions of subparagraph (2) of this paragraph. However, except in the case of amounts to which sections 402 and 403 apply, the tax, for taxable years beginning before January 1, 1964, attributable to the inclusion of all or part of the lump sum in gross income shall not exceed the amount determined under section 72(e)(3) and paragraph (g) of this section. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(2) There shall be excluded from gross income that portion of the lump sum which bears the same ratio to the aggregate premiums or other consideration paid for the contract, as reduced by all amounts previously received under the contract and excludable from

the gross income of the recipient under the applicable income tax law, as:

(i) In the case of payments to be made in the manner described in paragraph (b)(2) of §1.72-2, the amount of the reduction in the annuity payments to be made thereafter bears to the annuity payments originally provided under the contract, or

(ii) In the case of a contract providing for payments to be made in the manner described in paragraph (b)(3)(i) of §1.72-2, the amount of the reduction in the number of units per period to be paid thereafter bears to the number of units per period payable under the contract immediately before the lump sum withdrawal.

(3) This paragraph may be illustrated by the following examples:

*Example (1).* Taxpayer A pays \$20,000 for an annuity contract providing for payments to him of \$100 per month for his life. At the annuity starting date he has a life expectancy of 20 years. His expected return is therefore \$24,000 and the exclusion ratio is five-sixths. He continues to receive the original annuity payments for 5 years, receiving a total of \$6,000, and properly excludes a total of \$5,000 from his gross income in his income tax returns for those years. At the beginning of the next year, A agrees with the insurer to take a reduced annuity of \$75 per month and a lump sum payment of \$4,000 in cash. Of the lump sum he receives, he will include \$250 and exclude \$3,750 from his gross income for his taxable year of receipt, determined as follows:

Aggregate of premiums or other consideration paid .....	\$20,000
Less amounts received as an annuity to the extent they were excludable from A's income .....	\$5,000
Remainder of the consideration .....	\$15,000
Ratio of the reduction in the amount of the annuity payments to the original annuity payments .....	25/\$100 or 1/4
Lump sum received .....	\$4,000
Less one-fourth of the remainder of the consideration (1/4 of \$15,000) .....	\$3,750
Portion of the lump sum includible in gross income .....	\$250

For taxable years beginning before January 1, 1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum includible in gross income. For taxable years beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, in this example, the annuity were a pension payable to A as a retired employee,

but the facts were otherwise the same (assuming that, for instance, the \$20,000 aggregate of premiums or other consideration paid were A's contributions as determined under section 72(f) and §1.72-8) the result would be the same except that the tax attributable to the inclusion of the \$250 in A's gross income, for taxable years beginning before January 1, 1964, would not be limited by section 72(e)(3), as in effect before such date. If such a lump sum is received in a taxable year beginning after December 31, 1963, the portion of such sum includible in gross income may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

*Example (2).* Taxpayer B pays \$30,000 for a contract providing for monthly payments to be made to him for 15 years with respect to the principal and earnings of 10 units of an investment fund. B receives \$12,000 during the first 5 years of participation and of this amount he has properly excluded a total of \$10,000 from his gross income in his income returns for the taxable years, since \$2,000 of \$2,400 he received in each such year represented his investment divided by the term of the annuity (\$30,000÷15). At the beginning of the 6th year, B agrees to take \$11,000 in a lump sum and thereafter to accept the payments arising with respect to five units for the remaining 10 years of payments in full discharge of the original obligations of the contract. B shall include \$1,000 in his gross income for the 6th year as the result of the lump sum he receives and allocates \$1,000 of his original investment in the contract to each of the remaining 10 years with respect to the payments which will continue, determined as follows:

Aggregate of premiums or other consideration paid .....	\$30,000
Total amount received and excludable from gross income .....	\$10,000
Remainder of the consideration .....	\$20,000
Ratio of units discontinued to the total units originally provided .....	5/10 or 1/2
Lump sum received at the time of reduction in the number of units to be paid .....	\$11,000
Less one-half of the remainder of the consideration (1/2 of \$20,000) .....	\$10,000
Portion of the lump sum received and includible in gross income .....	\$1,000
Remainder of the consideration less the portion of such remainder attributable to the excludable portion of the lump sum (\$20,000 - \$10,000) .....	\$10,000
Remainder of the consideration properly allocable to each taxable year for the remaining 10 years (\$10,000÷10) .....	\$1,000

For the taxable years beginning before January 1, 1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum received and includible in gross income. For taxable years

## § 1.72-12

## 26 CFR Ch. I (4-1-04 Edition)

beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(g) *Limit on tax attributable to the receipt of a lump sum.* (1) For taxable years beginning before January 1, 1964, if the entire amount of the proceeds received upon the redemption, maturity, surrender, or discharge of a contract to which section 72 applies is received in a lump sum and paragraph (c), (d), or (f) of this section is applicable in determining the portion of such amount which is includible in gross income, the tax attributable to such portion shall not exceed the tax which would have been attributable thereto had such portion been received ratably in the taxable year in which received and the 2 preceding taxable years. The amount of tax attributable to the includible portion of the lump sum received shall be the lesser of:

(i) The difference between the amount of tax for the taxable year of receipt computed by including such portion in gross income and the amount of tax for such taxable year computed by excluding such portion from gross income; or

(ii) The difference between the total amount of tax for the taxable year of receipt and the 2 preceding taxable years computed by including one-third of such portion in gross income for each of the 3 taxable years, and the total amount of the tax for the taxable year of receipt and the 2 preceding taxable years computed by entirely excluding such portion from the gross income of all 3 taxable years.

For the definition of "taxable year", see section 441(b). This subparagraph shall not apply, for taxable years beginning before January 1, 1964, to payments excepted from the application of section 72(e)(3), as in effect before such date, under the provisions of section 402 or 403. See paragraph (a) of § 1.72-2 and paragraph (d) of § 1.72-14.

(2) For taxable years beginning after December 31, 1963, any amount includible in gross income to which this section relates may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(h) *Amounts deemed to be paid or received by a transferee.* Amounts deemed to have been paid or received by a transferee for the purposes of § 1.72-10 shall also be deemed to have been so paid or received by such transferee for the purposes of this section. Thus, if a donee is deemed to have paid the premiums or other consideration actually paid by his transferor for the purposes of section 72(g) and paragraph (b) of § 1.72-10, such consideration shall be deemed premiums or other consideration paid by the donee for the purposes of this section.

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### § 1.72-12 Effect of taking an annuity in lieu of a lump sum upon the maturity of a contract.

If a contract to which section 72 applies provides for the payment of a lump sum in full discharge of the obligation thereunder and the obligee entitled thereto, prior to receiving any portion of such lump sum and within 60 days after the date on which such lump sum first becomes payable, exercises an option or irrevocably agrees with the obligor to take, in lieu thereof, payments which will constitute "amounts received as an annuity", as that term is defined in paragraph (b) of § 1.72-2, no part of such lump sum shall be deemed to have been received by the obligee at the time he was first entitled thereto merely because he would have been entitled to such amount had he not exercised the option or made such an agreement with the obligor.

### § 1.72-13 Special rule for employee contributions recoverable in three years.

(a) *Amounts received as an annuity.* (1) Section 72(d) provides a special rule for the treatment of amounts received as an annuity by an employee (or by the beneficiary or beneficiaries of an employee) under a contract to which section 72 applies. This special rule is applicable only in the event that:

(i) At least part of the consideration paid for the contract is contributed by the employer, and

(ii) The aggregate amount receivable as an annuity under such contract by