in Tables V through VIII of § 1.72–9 with respect to the post-June 1986 investment in the contract.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8115, 51 FR 45694, Dec. 19, 1986]

§ 1.72–6 Investment in the contract.

(a) *General rule.* (1) For the purpose of computing the ''investment in the contract'', it is first necessary to determine the ''aggregate amount of premiums or other consideration paid'' for such contract. See section 72(c)(1). This determination is made as of the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity. The amount so found is then reduced by the sum of the following amounts in order to find the investment in the contract:

(i) The total amount of any return of premiums or dividends received (including unrepaid loans or dividends applied against the principal or interest on such loans) on or before the date on which the foregoing determination is made, and

(ii) The total of any other amounts received with respect to the contract on or before such date which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt.

Amounts to which subdivision (ii) of this subparagraph applies shall include, for example, amounts considered to be return of premiums or other consideration paid under section 22(b)(2) of the Internal Revenue Code of 1939 and amounts considered to be an employer-provided death benefit under section 22(b)(1)(B) of such Code. For rules relating to the extent to which an employee or his beneficiary may include employer contributions in the aggregate amount of premiums or other consideration paid, see § 1.72–8. If the aggregate amount of premiums or other consideration paid for the contract includes amounts for which deductions were allowed under section 404 as contributions on behalf of a self-employed individual, such amounts shall not be included in the investment in the contract.

(2) For the purpose of subparagraph (1) of this paragraph, amounts received subsequent to the receipt of an amount as an annuity or subsequent to the annuity starting date, whichever is the later, shall be disregarded. See, however, § 1.72–11.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). In 1950, B purchased an annuity contract for $10,000 which was to provide him with an annuity of $1,000 per year for life. He received $1,000 in each of the years 1950, 1951, 1952, and 1953, prior to the annuity starting date (January 1, 1954). Under the Internal Revenue Code of 1939, $300 of each of these payments (3 percent of $10,000) was includible in his gross income, and the remaining $700 was excludable therefrom during each of the taxable years mentioned. In computing B's investment in the contract as of January 1, 1954, the total amount excludable from his gross income during the years 1950 through 1953 ($2,800) must be subtracted from the consideration paid ($10,000). Accordingly, B's investment in the contract as of January 1, 1954, is $7,200 ($10,000 less $2,800).

Example (2). In 1945, C contracted for an annuity to be paid to him beginning December 31, 1960. In 1945 and in each successive year until 1960, he paid a premium of $5,000. Assuming he receives no payments of any kind under the contract until the date on which he receives the first annual payment as an annuity (December 31, 1960), his investment in the contract as of the annuity starting date (December 31, 1959) will be $75,000 ($5,000 paid each year for the 15 years from 1945 to 1959, inclusive).

Example (3). Assume the same facts as in example (2), except that prior to the annuity starting date C has already received from the insurer dividends of $1,000 each in 1949, 1954, and 1959, such dividends not being includible in his gross income in any of those years. C's investment in the contract, as of the annuity starting date, will then be $72,000 ($75,000–$3,000).

(b) *Allocation of the investment in the contract where two or more annuity elements are acquired for a single consideration.* (1) In the case of a contract described in § 1.72–2(a)(2) which provides for two or more annuity elements, the investment in the contract determined under paragraph (a) shall be allocated to each of the annuity elements in the ratio that the expected return under each annuity element bears to the aggregate of the expected returns under all the annuity elements. The exclusion ratio for the contract as a whole shall be determined by dividing the investment in the contract (after adjustment for the present value of any or all refund features) by the aggregate of the expected returns under all the annuity elements. This may be illustrated by the following examples:

Example (1). If a contract provides for annuity payments of $1,000 per year for life (with no refund feature) to both A and B, a male and female, respectively, each 70 years of age as of the annuity starting date, such contract is acquired for consideration of $19,575 (without regard to whether paid by A, B, or both), and there is no post-June 1986 investment in the contract, the investment in the contract shall be allocated by determining the exclusion ratio for the contract as a whole in the following manner:

Expectancy of A under Table I and §1.72–5(a)(2), 11.6 (12.1–0.5), multiplied by $1,000	$11,600
Plus: Expectancy of B computed in a similar manner ($1,000×14.5 [15.0 − 0.5])	14,500
Total expected return	26,100

The exclusion ratio for both A and B is then $19,575÷$26,100, or 75 percent. A and B shall each exclude from gross income three-fourths ($750) of each $1,000 annual payment received and shall include the remaining one-fourth ($250) of each $1,000 annual payment received in gross income.

Example (2). Assume the same facts as in example (1) except that of the total investment in the contract of $19,575, the pre-July 1986 investment in the contract is $10,000. If the election described in §1.72–6(d)(6) is made with respect to the contract, the investment in the contract shall be allocated by determining an exclusion ratio for the contract as a whole based on separately computed exclusion ratios with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract in the following manner:

Expectancy of A under Table I and §1.72–5(a)(2), 11.6 (12.1–0.5), multiplied by $1,000	$11,600
Plus: Expectancy of B under Table I and §1.72–5(a)(2), 14.5 (15.0–0.5), multiplied by $1,000	$14,500
Pre-July 1986 expected return	$26,100
Expectancy of A under Table V and §1.72–5(a)(2), 15.5 (16.0–0.5), multiplied by $1,000	$15,500
Plus: Expectancy of B under Table V and §1.72–5(a)(2), 15.5 (16.0–0.5), multiplied by $1,000	$15,500
Post-June 1986 expected return	$31,000
Pre-July 1986 exclusion ratio ($10,000÷$26,100)	38.3
Post-June 1986 exclusion ratio ($9,575÷31,000)	30.9

A and B shall each exclude from gross income $692 (38.3 percent of $1,000+30.9 percent of $1,000) of each $1,000 payment and include the remaining $308 in gross income

(2) In the case of a contract providing for specified annual annuity payments to be made to two persons during their joint lives and the payment of the aggregate of the two individual payments to the survivor for his life, the investment in the contract shall be allocated in accordance with the provisions of subparagraph (1) of this paragraph. For this purpose, the investment in the contract (without regard to the fact that differing amounts may have been contributed by the two annuitants) shall be divided by the expected return determined in accordance with paragraph (e)(4) of §1.72–5. The resulting exclusion ratio shall then be applied to any amounts received as an annuity by either annuitant.

(3) In the case of a contract providing two or more annuity elements, one or more of which provides for payments to be made in a manner described in paragraph (b)(3) of §1.72–2, the investment in the contract shall be allocated to the various annuity elements in the following manner.

(i) If all the annuity elements provide for payments to be made in the manner described in paragraph (b)(3) of §1.72–2, the investment in the contract shall be allocated on the basis of the amounts received by each recipient by apportioning the amount determined to be excludable under that section to each recipient in the same ratio as the total of the amounts received by him in the taxable year bears to the total of the amounts received by all recipients during the same period; and

(ii) If one or more, but not all, of the annuity elements provide for payments to be made in a manner described in paragraph (b)(3) of §1.72–2:

(*a*) With respect to all annuity elements to which that section does not apply, the investment in the contract for all such elements shall be the portion of the investment in the contract as a whole (found in accordance with the provisions of this section) which is properly allocable to all such elements; and

(*b*) With respect to all annuity elements to which paragraph (b)(3) of § 1.72–2 does apply, the investment in the contract for all such elements shall be the investment in the contract as a whole (found in accordance with the provisions of this section) as reduced by the portion thereof determined under (*a*) of this subdivision.

For the purpose of determining, pursuant to (*a*) of this subdivision, the portion of the investment in the contract as a whole properly allocable to a particular annuity element, reference shall be made to the present value of such annuity element determined in accordance with paragraph (e)(1)(iii) (*b*) of § 1.101–2.

(iii) In the case of a contract to which paragraph (d) of this section applies, this paragraph (b) is applied in the manner prescribed in paragraph (d) and, in particular, paragraph (d)(5)(v) of this section.

(c) *Special rules.* (1) For the special rule for determining the investment in the contract for a surviving annuitant in cases where the prior annuitant of a joint and survivor annuity contract died in 1951, 1952, or 1953, see paragraph (b)(3) of § 1.72–5.

(2) For special rules relating to the determination of the investment in the contract where employer contributions are involved, see § 1.72–8. See also paragraph (b) of § 1.72–16 for a special rule relating to the determination of the premiums or other consideration paid for a contract where an employee is taxable on the premiums paid for life insurance protection that is purchased by and considered to be a distribution from an exempt employees' trust.

(3) For the determination of an adjustment in investment in the contract in cases where a contract contains a refund feature, see § 1.72–7.

(4) In the case of ''face-amount certificates'' described in section 72(1), the amount of consideration paid for purposes of computing the investment in the contract shall include any amount added to the holder's basis by reason of section 1232(a)(3)(E) (relating to basis adjustment for amount of original issue discount ratably included in gross income as interest under section 1232(a)(3)).

(d) *Pre-July 1986 and post-June 1986 investment in the contract.* (1) This paragraph (d) applies to an annuity contract if:

(i) The investment in the contract includes a pre-July 1986 investment in the contract and a post-June 1986 investment in the contract (both as defined in § 1.72–6(d)(3));

(ii) The use of a multiple found in Tables I through VIII of § 1.72–9 is required to determine the expected return under the contract; and

(iii) The election described in paragraph (d)(6) of this section is made with respect to the contract.

(2) In the case of annuity contract to which this paragraph (d) applies—

(i) All computations required to determine the amount excludable from gross income shall be performed separately with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract as if each such amount were the entire investment in the contract;

(ii) The multiples in Tables I through IV shall be used for computations involving the pre-July 1986 investment in the contract and the multiples in Tables V through VIII shall be used for computations involving the post-June 1986 investment in the contract; and

(iii) The amount excludable from gross income shall be the sum of the amounts determined under the separate computations required by paragraph (d)(2)(i) of this section.

(3) For purposes of the regulations under section 72, the pre-July 1986 investment in the contract and post-June 1986 investment in the contract are determined in accordance with the following rules:

(i)(A) Except as provided in § 1.72–9, if the annuity starting date of the contract occurs before July 1, 1986, the pre-July 1986 investment in the contract is the total investment in the contract as of the annuity starting date;

(B) Except as provided in § 1.72–9, if the annuity starting date of the contract occurs after June 30, 1986, and the contract does not provide for a disqualifying form of payment or settlement, the pre-July 1986 investment in the contract is the investment in the contract computed as of June 30, 1986, as if June 30, 1986, had been the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity;

(C) If the annuity starting date of the contract occurs after June 30, 1986, and the contract provides, at the option of the annuitant or of any other person (including, in the case of an employee's annuity, an option exercisable only by, or with the consent of, the employer), for a disqualifying form of payment or settlement, the pre-July 1986 investment in the contract is zero (i.e., the total investment in the contract is post-June 1986 investment in the contract).

(ii) The post-June 1986 investment in the contract is the amount by which the total investment in the contract as of the annuity starting date exceeds the pre-July 1986 investment in the contract.

(iii) For purposes of paragraph (d)(3)(i) of this section, a disqualifying form of payment or settlement is any form of payment or settlement (whether or not selected) that permits the receipt of amounts under the contract in a form other than a life annuity. For example, each of the following options provides for a disqualifying form of payment or settlement:

(A) An option to receive a lump sum in full discharge of the obligation under the contract.

(B) An option to receive an amount under the contract after June 30, 1986, and before the annuity starting date.

(C) An option to receive an annuity for a period certain.

(D) An option to receive payments under a refund feature (within the meaning of paragraphs (b) and (c) of § 1.72–7) that is substantially equivalent to an annuity for a period certain.

(E) An option to receive a temporary life annuity (within the meaning of § 1.72–5 (a)(3)) that is substantially equivalent to an annuity for a period certain.

An option to receive alternative forms of life annuity is not a disqualifying option for purposes of paragraph (d)(3)(i) of this section. Thus, if the sole options provided under a contract are a single life annuity and a joint and survivor life annuity, paragraph (d)(3)(i)(C) of this section does not apply to such contract.

(iv) For purposes of paragraph (d)(3)(iii) of this section, a refund feature is substantially equivalent to an annuity for a period certain if its value determined under Table VII of § 1.72–9 exceeds 50 percent. Similarly, a temporary life annuity is substantially equivalent to an annuity for a period certain if the multiple determined under Table VIII of § 1.72–9 exceeds 50 percent of the maximum duration of the annuity.

(4) In any separate computation under this paragraph (d), only the applicable portion of other amounts (such as the total expected return under the contract, or the total amount guaranteed under the contract as of the annuity starting date) shall be taken into account if the use of the entire amount in such computation is inconsistent with the use in the computation of only a portion of the investment in the contract. For example, such use is generally inconsistent if the computation requires a comparison of the investment in the contract and such other amount for the purpose of using the greater (or lesser) amount or the difference between the two. For purposes of the first sentence of this paragraph (d)(4), the applicable portion is the amount that bears the same ratio to the entire amount as the pre-July 1986, investment in the contract or the post-June 1986 investment in the contract, whichever is applicable, bears to the total investment in the contract as of the annuity starting date.

(5) *Application to particular computations.* (i) In the case of a contract to which this paragraph (d) applies, the exclusion ratio for purposes of § 1.72–4 (a) is the sum of the exclusion ratios separately computed in accordance with this paragraph (d). The exclusion ratio with respect to the pre-July 1986 investment in the contract is determined by dividing the pre-July 1986 investment in the contract by the expected return as found under § 1.72–5 by applying the appropriate multiples of

Tables I through IV of § 1.72–9. Similarly, the exclusion ratio with respect to the post-June 1986 investment in the contract is determined by dividing the post-June 1986 investment in the contract by the expected return as found under § 1.72–5 by applying the appropriate multiples in Tables V through VIII of § 1.72–9.

(ii) The applicability of § 1.72–4(d)(2) to a contract to which this paragraph (d) applies shall be determined separately with respect to the post-June 1986 investment in the contract and the pre-July 1986 investment in the contract and in each such determination only the applicable portion of the total expected return under the contract shall be taken into account. If § 1.72–4(d)(2) applies with respect to either such investment in the contract, the separately computed exclusion ratio shall be considered to be the applicable portion of 100 percent.

(iii) If § 1.72–4(d)(3) applies to a contract to which this paragraph (d) applies—

(A) The applicable portions (as defined in paragraph (d)(4) of this section) of payments received under the contract for a taxable year shall be separately computed;

(B) The pre-July 1986 investment in the contract and the post-June 1986 investment in the contract shall be separately allocated to the taxable year; and

(C) The separate applicable portions of the payments received under the contract for the taxable year shall be considered to be amounts received as an annuity (for which the exclusion ratio is 100 percent) only to the extent they do not exceed the portions of the corresponding investments in the contract which are properly allocable to that year.

See the example in § 1.72–4(d)(3)(v).

(iv) If § 1.72–4(e) applies to a contract to which this paragraph (d) applies, the exclusion ratio shall be separately computed with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract. For purposes of the separate computations under § 1.72–4(e)(2)(ii), only the applicable portion of payments received shall be taken into account and the exclusion ratio (100%) shall be applied to the separately computed portion allocated to each participant.

(v) If paragraph (b)(3) of this section applies to a contract to which this paragraph (d) applies, separate allocations are required with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract.

For purposes of the separate computations required to determine the portion of the investment in the contract properly allocable to a particular annuity element, only the applicable portion of the present value of the annuity element determined in accordance with § 1.101–2(e)(1)(iii)(b) is taken into account.

(vi) If § 1.72–7 applies to a contract to which this paragraph (d) applies, separate computations are required to determine the adjustment to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract. For purposes of such separate computations, only the applicable portions of the amounts described in § 1.72–7 (b)(3)(ii), (c)(1)(ii)(B), (c)(2)(vii)(B), and (d)(1)(ii) are taken into account. Similarly, in the case of computations with respect to the guarantee of a specified amount under § 1.72–7(d)(1), only the applicable portion of such amount is taken into account.

(6) This paragraph (d) applies to a contract only if the first taxpayer to receive an amount as an annuity under the contract elects to perform separate computations with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract as if each such amount were the entire investment in contract. If two or more annuitants receive an amount as an annuity under the contract at the same time (such as under a joint-and-last-survivorship annuity contract), an election by one of the annuitants is treated as an election by each of the annuitants. The election is made by attaching a statement to the first return filed by the taxpayer for the first taxable year in which an amount is received as an annuity under the contract. The statement must indicate that the taxpayer is electing to apply the provisions of paragraph (d) of § 1.72–6, and must also contain the

name, address, and taxpayer identification number of each annuitant under the contract, and the amount of the pre-July 1986 investment in the contract.

(7) If the investment in the contract includes a post-June 1986 investment in the contract and the election described in paragraph (d)(6) of this section is not made—

(i) The amount excludable from gross income shall be determined without regard to the separate computations described in this paragraph (d); and

(ii) Only the multiples found in Tables V through VIII shall be used in determining the amount excludable from gross income.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10134, Sept. 17, 1963; T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 8115, 51 FR 45700, Dec. 19, 1986; 52 FR 10223, Mar. 31, 1987]

§ 1.72–7 Adjustment in investment where a contract contains a refund feature.

(a) *Definition of a contract containing a refund feature.* A contract to which section 72 applies, contains a refund feature if:

(1) The total amount receivable as an annuity under such contract depends, in whole or in part, on the continuing life of one or more persons,

(2) The contract provides for payments to 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 has not been paid to the annuitant or annuitants prior to death, and

(3) Such payments are in the nature of a refund of the consideration paid. See paragraph (c)(1) of § 1.72–11.

(b) *Adjustment of investment for the refund feature in the case of a single life annuity.* Where a single life annuity contract to which section 72 applies contains a refund feature and the special rule of paragraph (d) of this section does not apply, the investment in the contract shall be adjusted in the following manner:

(1) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract to the extent such amount reduces the guaranteed amount. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(2) Consult Table III or VII (whichever is applicable) of § 1.72–9 for the appropriate percentage under the whole number of years found in subparagraph (1) of this paragraph and the age (as of the annuity starting date) and, if applicable, sex of the annuitant.

(3) Multiply the percentage found in subparagraph (2) of this paragraph by whichever of the following is the smaller: (i) The investment in the contract found in accordance with § 1.72–6 or (ii) the total amount guaranteed as of the annuity starting date.

(4) Subtract the amount found in subparagraph (3) of this paragraph from the investment in the contract found in accordance with § 1.72–6.

The resulting amount is the investment in the contract adjusted for the present value of the refund feature without discount for interest and is to be used in determining the exclusion ratio to be applied to the payments received as an annuity. The percentage found in Tables III or VII shall not be adjusted in a manner described in paragraph (a)(2) of § 1.72–5. These principles may be illustrated by the following examples:

Example (1). On January 1, 1954, a husband, age 65, purchased for $21,053, an immediate installment refund annuity payable $100 per month for life. The contract provided that in the event the husband did not live long enough to recover the full purchase price, payments were to be made to his wife until the total payments under the contract equaled the purchase price. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)	$21,053
Amount to be received annually	$1,200
Number of years for which payment guaranteed ($21,053 divided by $1,200)	17.5
Rounded to nearest whole number of years	18