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The Expected return and Investment in contract are used to calculate the portion of each annuity payment that will be excluded from income as a tax-free return of principal. This exclusion ratio is calculated by dividing the Investment in contract (the fair market value of the gift less the charitable deduction) by the Expected return (the total amount in annuity payments expected to be returned to the beneficiaries).(1) The exclusion ratio is rounded at three decimal places (one-tenth of one percent). The exclusion ratio is the portion of each anticipated payment that will be considered a part of the donor's original investment rather than ordinary income earned on that money. The portion of each annuity payment excluded from income reduces the "unrecovered" investment in contract. Once the investment in contract has been recovered, these portions of each annuity payment can no longer be excluded and the whole annuity payment becomes taxable. If the donor does not live until life expectancy, when the investment in contract will be fully recovered, there is a deduction for the unrecovered investment. Footnotes: (1) IRC Sec. 72(b); see also Treas. Reg. Secs. 1.72-4, 1.1011-2(c) Example (8)(d). (2) I.R.C. Sec. 72(b)(4). (3) I.R.C. Sec. 72(b)(2). (4) I.R.C. Sec. 72(b)(3).

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