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An annuitant's investment in contract in a gift annuity equals the present value of the annuitant's income interest. An annuitant's unrecovered investment in contract equals the total amount of tax-free payments that he would have received had he lived to reach his life expectancy, minus the total amount of tax-free payments that he actually received while alive. Capital gain income is not considered when computing an annuitant's unrecovered investment in contract.

Under IRC Sec. 72(b)(3), if the annuitant dies prior to reaching his or her life expectancy and there is no surviving annuitant, the IRS allows an income tax deduction on the deceased annuitant's final income tax return for his unrecovered investment in contract. This is a miscellaneous deduction, not a charitable deduction, and is not subject to the 2% floor that applies to certain miscellaneous deductions.

This rule applies to gift annuities funded on or after January 1, 1987 only. Pre-1987 annuities are able to make partially tax-free payments for their duration, regardless of how long they last. Consequently, the deduction for unrecovered investment in contract is not available for these annuities.

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