

STATE OF DELAWARE
DEPARTMENT OF FINANCE
DIVISION OF REVENUE
601 DELAWARE AVENUE
WILMINGTON, DELAWARE 19899

TAX NEWSGRAM 71-3

December 6, 1971

PERSONAL INCOME TAX

- Annuity Income - Modification

QUESTION: Will the treatment of annuity and pension income change due to the new Income Tax Law:

Yes. Federal adjusted gross income will include income from annuities and pensions. Prior to 1971 the computation of taxable annuity and pension amount to be reported for Federal purposes was different than the State's.

Pension

On the federal return if the investment of the taxpayer was returnable in less than 3 years the taxpayer excluded all payments until his investment was returned in full. Then all payments became taxable. If this was considered an annuity for State purposes the computation was the same. But usually this was a type of annuity which was considered a pension. The reason was that the employee and employer contributed toward the pension. In which case taxpayer excluded \$2,000 a year, each year, without regard to the amount he paid toward the pension.

Example

Taxpayer paid \$6,500 toward his pension and his employer paid the balance. He received \$3,000 a year. Under the federal law \$3,000 was exempt the first two years and \$500 the third year after which the total was taxable. The state excluded \$2,000 each year and \$1,000 was taxable each year. Assume the first payment on the pension was received 1/1/69. The computation of the annuity-pension would be as follows:

	<u>Federal</u>	<u>State</u>
Investment	\$6,500	\$6,500
Exclude 1969	\$3,000	1969 \$2,000
1970	<u>3,000</u>	1970 <u>2,000</u>
Recovered tax free 12/31/70	<u>6,000</u>	<u>4,000</u>
Unrecovered investment 1/1/71	500	2,500
Excluded in 1971	<u>500</u>	
Total to be reported on Federal return	2,500	
Total to be reported on State return	500	

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Taxpayer would show computation and explain the reduction as an adjustment on the 1971 return.

No adjustment would be required on 1972 and subsequent returns as the full amount would be taxable, because taxpayers have fully recovered their basis for State tax purposes.

Annuity

On the federal return when taxpayer purchased an annuity (usually from an insurance company) the Internal Revenue Service required three facts:

1. His investment in Contract (Total cost)
2. His expected return (based on life expectancy or guarantee payments)
3. Monthly or yearly payments

This is known as the "Exclusion Ratio" Formula

Assume that taxpayer purchases an annuity for \$10,000 which begins 1/1/69. Payments are to be made for 10 years at \$100 per month (\$1,200 a year). To compute the exclusion ratio or adjustment which must be made on the 1971 and subsequent year return.

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|----|------------------------|----------|
| 1. | Investment in Contract | \$10,000 |
| 2. | Expected return | 12,000 |
| 3. | Yearly payments | 1,200 |

Exclusion ratio $10,000/12,000$ or $5/6$ for federal purposes =

1,000 excluded - \$200 included in income.

For state purposes the entire \$1,200 received each year, prior to 1971, would be excluded until the cost was recovered. In 1971 taxpayer would have to explain the difference between his federal exclusion and the state's exclusion and report same as a modification.

Computation:

Federal Reports \$200 each year as income

The state would be computed as follows:

Investment			\$10,000
Received tax free	1969	1,200	
	1970	<u>1,200</u>	
Total received			<u>2,400</u>
Investment in Contract			\$ 7,600

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Expected return 8 years@ 1,200	9,600
Yearly payments	1,200

Exclusion ratio $7,600/9,600 = .79166\%$ return of investment
.20833% taxable

Taxable each year for state purposes \$250.00

Taxpayer would report adjustment to increase income of \$50.00 each year. He should explain in detail.

EDITOR'S NOTE: For pensions and annuities starting in 1971 there are no adjustments as the method of reporting will be the same as on the Federal Tax return.

There are other types of annuity income which use as a factor the expected Life of the Annuitant at the time payments begin. The annuity may cover the life of one (husband) plus the life of another (wife). To compute these we will need additional information. As requests are made for help in these areas the information will be communicated to Division of Revenue personnel.


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Director of Revenue

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