

ordinary income.⁹ Once the amount of the owner's investment in the PPVA is fully recovered, subsequent payments are fully included as ordinary income without reduction.

a. Recovery of Invested Amounts upon Death

If the owner of a PPVA dies and the account value is below adjusted basis, the taxpayer is generally permitted to deduct in his or her final return an amount equal to the remaining unrecovered investment in the annuity as an ordinary loss.¹⁰ There is a special carryback rule that permits the deduction to be carried back to prior tax years.¹¹ If the PPVA account value is above adjusted basis, distributions in excess of the adjusted basis are taxed at ordinary income rates and additional distributions are free of tax.¹²

2. Other Distributions Taken from the PPVA

With respect to other unscheduled payments not considered to be amounts received as an annuity, *e.g.*, cash withdrawals or complete surrender of the PPVA, the extent to which such amounts are included in the gross income of the holder of the PPVA will depend on when the amounts are received, the nature of the distribution and whether the amounts may be considered a return on investment in the contract.

For amounts received in full discharge of the obligation under the PPVA in complete surrender, redemption or maturity, the amount included as ordinary income is reduced to the extent the payment is treated as in the nature of a refund of the consideration paid for the PPVA, *i.e.*, income is reduced by the amount of unrecovered investment in the PPVA.¹³

If the amount is received on the PPVA before the annuity starting date, the payment is included in gross income to the extent allocable to income from the PPVA and is not included in gross income to the extent allocable to the investment in the PPVA.¹⁴ For this purpose, an amount is treated as allocable to income with respect to the PPVA to the extent that such amount, net of surrender charges (if applicable), is in excess of adjusted basis. Once the investment gain element of the PPVA has been fully distributed, subsequent payment amounts are treated as in the nature of a refund of the consideration paid for the PPVA and are thereby exempt from income tax.

⁹ Treas. Reg. § 1.72-2(b)(3). If an amount received is less than the return on investment, the holder may elect in a succeeding tax year in which payment is received to redetermine the amounts received to take into account the amount that would have been excludible had it been received in the earlier year.

¹⁰ I.R.C. § 72(b)(3)(A).

¹¹ I.R.C. § 72(b)(3)(C).

¹² If there are annuity payments to the owner of a PPVA before death, then these rules apply to the amount received at death, and the rules described in the previous paragraphs apply to pre-death payments to the owner of a PPVA.

¹³ I.R.C. § 72(e)(5)(E).

¹⁴ I.R.C. § 72(e)(2)(B).