The Advanced Consulting Group

White paper

Valuing annuity benefits for required minimum distribution and Roth conversions purposes

Thomas H. Duncan, JD, CLU®, ChFC®
Senior Director, Advanced Consulting Group

Key highlights

- How RMDs are calculate
- Entire interest rule
- How actuarial present value is calculated
- Determining the fair market value of variable annuities

When deferred annuities are owned by qualified accounts these guarantees must be taken into account when calculating required minimum distributions (RMD) and the taxable amount of a Roth IRA conversion.

How are RMDs calculated generally?

To calculate the RMD amount, the taxpayer must use the prior year 12/31 account balance and divide that number by the appropriate life expectancy factor:

$$\text{RMD amount} = \frac{\text{Prior year 12/31 account balance}}{\text{Life expectancy factor}}$$

Valuing annuity benefits for RMD purposes — Entire interest rule

Starting on January 1, 2006, the IRS mandated that RMDs from qualified accounts holding deferred annuities as investments must be based on the "entire interest under an annuity contract." Which means the RMD calculation must include the prior year December 31 account balance *plus* the actuarial present value of any additional living or death benefits, the so-called "combined value". Annuity providers are required to include this combined value in the year end RMD reporting to the client.

$$\text{RMD amount} = \frac{\text{Prior year 12/31 account balance } + \text{ annuity benefits actuarial present value}}{\text{Life expectancy factor}}$$

Exceptions to the entire interest rule

There are two exceptions to this rule that may allow the client to use only the 12/31 account balance instead of the combined value when calculating RMDs:

1. If the only additional benefit provided under the contract is a return of premium death benefit, its value may be disregarded in determining the entire interest in the annuity; or,
2. If the additional benefit does not exceed the actual value by 20% of the contract's account value and the contract only includes the following additional benefits:
   a. Additional benefits are reduced at least proportionately for withdrawals; and,
   b. An additional benefit that provides a return of premium upon death.

Absent one of these exceptions then the combined value must be used in the RMD calculation.

Practical effect of the entire interest rule

It is likely that the only time that the "entire interest rule" will increase the RMD calculation is when the guaranteed values provided under the contract are significantly greater than the 12/31 account value.

How is actuarial present value calculated?

The IRS has not provided specific plug-and-play guidance as to how carriers must value the additional benefits, it has provided general guidance. Thus, each annuity provider must develop its own methods of valuation based on a reasonableness standard. Regardless of the method used, the results of this calculation, the combined value, must be delivered to the client as part of the normal RMD reporting process.

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Nationwide reports the RMD value of the annuity (12/31 account value *plus* actuarial net present value of any additional living or death benefits) to the client, or their broker/dealer for custodial accounts, on the fourth quarter account statement by January 31.

What is the client supposed to do with the RMD?

If the combined value exceeds the 12/31 account value by 20% or more, than the combined value must be used in the RMD calculation.

The easiest way to determine which value to use for RMD purposes, combined value or only 12/31 account balance, is to multiple the 12/31 account balance by 120%, or 1.2, and then compare that number to the combined value. If the combined value is greater than the 12/31 account balance multiplied by 1.2 then the combined valued becomes the RMD divisible amount. If the 12/31 account balance multiplied by 1.2 is greater than the combined value then only the 12/31 account balance should be used as the RMD divisible amount provided the benefit meets the other exception criteria.

For example, assume the 12/31 account value of an annuity is $110,000 and the combined value of the annuity is $160,000.

To determine the appropriate RMD value to use, multiply the 12/31 account balance by 1.2, and then compare the 120% value to the combined value. In our example because the combined value ($160,000) is greater than the 120% value ($110,000 x 1.2 = $132,000) the combined value ($160,000) must be used as the RMD divisible amount.

Assuming the client is 75 years old then the RMD amount would be $6,986.89.

$$\frac{\$160{,}000 \text{ (RMD value)}}{22.9 \text{ (Uniform table life expectancy factor)}} = \$6{,}986.89$$

RMD and annuity benefits conclusion

Care should be taken to properly understand the valuation ramifications of having deferred annuities with living and/or death benefits in qualified accounts when in the RMD phase. These valuation ramifications must then be balanced against the benefits that such annuity features can provide such as, lifetime income, guaranteed growth for income purposes and estate protection, to see if these products make sense for clients.

Roth IRA conversions — Determining the fair market value of variable annuities

The lifting of income limitations on Roth IRA Conversions in 2010 created a flurry of interest in the concept; however, the conversion of a Traditional IRA or qualified plan that is invested in an annuity has some special considerations. These considerations include ensuring that the amount subject to taxation from the conversion must be the "fair market value" of the annuity. Fair market value means not only the account balance of the annuity on the date of conversion but the actuarial net present value of any living or death benefit guarantees as well; again a so-called combined value.

The IRS issued this rule in August 2005 to curb abuses of the conversion of deferred annuities with artificially low cash surrender values and/or dollar-for-dollar withdrawal procedures, because they were being converted to Roth IRAs at periods of low cash value relative to future benefits without those future benefits being able to be taxed. The regulations now require that the method used by the company to value these benefits must reflect the full value of the contract, and if it does not then that method may not be used.

This combined value for Roth conversions rule could increase the conversion's taxable amount beyond just the account balance of the converted amount. Investment professionals undertaking a Roth IRA conversion with monies invested in a deferred annuity should be prepared for this additional taxable amount and understand that it will have an effect on the cash necessary to pay the taxes due on the conversion.

Annuity providers must perform this calculation and provide the combined value to the client and the IRS as part of the normal course of tax reporting Roth IRA conversions.

However, even given this potential increase in the taxable amount due to the annuity's guarantees, a conversion of an annuity with guaranteed values greater than the cash value could be beneficial because it would allow the future growth in both the account value and guarantee values to be received by the client or their beneficiaries' income tax-free.[1]

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[1] The distributions from Roth IRAs are income tax free if the account owner is over age 59 ½ and it is at least five years from the first Roth IRA funding. Converted amounts can be withdrawn from Roth IRAs 10% penalty tax free if the account owner is over age 59 ½ or it's been over five years since the conversion. Contributions can be withdrawn income tax free at anytime.

Withdrawals of earnings by beneficiaries may be income-tax free if the Roth IRA is over five years old, inclusive of the time when the owner was alive.

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